Supreme Court, U.S.
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No. 04-

IN THE

Supreme Court of the United States

IRVING PULP & PAPER, LIMITED d/b/a IRVING PAPER,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 364 of the Bankruptcy Code, 11 U.S.C. § 364, authorizes a chapter 11 debtor to borrow money and obtain goods and services on credit. In many chapter 11 cases, debtors seek to borrow money or obtain goods and services on credit from preexisting lenders and suppliers. In order to encourage a preexisting lender or supplier to extend credit, the debtor typically requests the bankruptcy court to approve credit terms favorable to the lender or supplier, including the treatment of the creditor's unpaid pre-petition claim as a priority obligation in the debtor's bankruptcy case.

Section 364(e) of the Code, 11 U.S.C. § 364(e), prevents an appellate court from overturning an authorized credit transaction to a lender or supplier that extends credit in good faith unless the party objecting to the transaction first obtained a stay of the transaction pending appeal. The question presented is:

Should the Court grant certiorari to resolve a three-way circuit conflict over whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification?

RULE 29.6 STATEMENT AND PARTIES TO THE PROCEEDING

Petitioner is Irving Pulp & Paper, Limited d/b/a Irving Paper. The parent companies of petitioner are The New Brunswick Railway Company, FMP Company, Limited, and K.C. Irving, Limited. No public company owns 10 percent or more of the stock of Irving Paper. Respondent is Capital Factors, Inc. Kmart Corporation, Handleman Company, and Knight-Ridder, Inc., were parties to the proceedings below.

TABLE OF CONTENTS

	Page
Question Presented	i
Rule 29.6 Statement and Parties to the Proceeding	ii
Table of Contents	iii
Table of Cited Authorities	v
Table of Appendices	x
Opinions Below	1
Jurisdiction	1
Relevant Statutory Provisions	1
Statement	2
Reasons for Granting the Petition	9
I. The Courts of Appeals Are Intractably Divided Into Three Camps Over the Question Presented and Review in this Court is Necessary and Warranted to Resolve the Conflict	9
A. Review Is Warranted Because the Courts of Appeals Are Divided over the Question Presented	12
B. Review Is Further Warranted Because the Decision of the Court Below Conflicts with the Decisions of Other Courts of Appeals on the Proper Application of Section 363(m) of the Bankruptcy Code – A Provision Nearly Identical to Section 364(e)	17

Contents

Page

C. Review Is Further Warranted Because the Conflict Will Not Resolve Itself Absent the Court's Intervention 20

D. This Case Presents an Ideal Vehicle for the Resolution of the Question Presented 21

II. The Conflict Among the Courts of Appeals is Untenable Given the Importance of the Question Presented 23

III. Certiorari Is Also Warranted Because the Decision of the Court Below Is Wrong on the Merits 24

Conclusion 30

TABLE OF CITED AUTHORITIES

Page

FEDERAL CASES

Anheuser-Busch, Inc. v. Miller (In re Stadium Mgmt. Corp.), 895 F.2d 845 (1st Cir. 1990) 19

Bank of America v. 203 North LaSalle St. P'ship, 526 U.S. 434 (1999) 23

Bank of New England v. BWL, Inc., 121 B.R. 413 (D. Me. 1990) 12

Boullioun Aircraft Holding Co. v. Smith Mgmt. (In re Western Pacific Airlines, Inc.), 181 F.3d 1191 (10th Cir. 1999) 10, 12, 16

Burchinal v. Central Washington Bank (In re Adams Apple, Inc.), 829 F.2d 1484 (9th Cir. 1987) ..... *passim*

Connecticut Nat'l Bank v. Germain, 503 U.S. 249 (1992) 24

In re Crawford, 324 F.3d 539 (7th Cir. 2003) 29

Credit Alliance Corp. v. Idaho Asphalt Supply, Inc. (In re Blumer), 95 B.R. 143 (9th Cir. BAP 1988) .. 3

Development Co. of America v. Adamson Co. (In re Adamson Co.), 159 F.3d 896 (4th Cir. 1998) 18

General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.), 739 F.2d 73 (2d Cir. 1984) 6

Cited Authorities

Page

Ginther v. The Ginther Trusts (In re The Ginther Trusts), 238 F.3d 686 (5th Cir. 2001) 18

Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A., 530 U.S. 1 (2000) 2, 3, 24

Hicks v. Pearlstein (In re Magwood), 785 F.2d 1077 (D.C. Cir. 1986) 19

In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004) 1, 10, 14, 15

Kontrick v. Ryan, __ U.S. __, 124 S. Ct. 906 (2004) 17

Lamie v. United States Trustee, __ U.S. __, 124 S. Ct. 1023 (2004) 24

Licensing By Paolo v. Sinatra (In re Gucci), 126 F.3d 380 (2d Cir. 1997) 18

L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs., Inc.), 209 F.3d 291 (3d Cir. 2000) 19

New York Life Ins. Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.), 901 F.2d 1359 (6th Cir. 1990) 10, 12, 16, 17

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1983) 23

Official Comm. of Unsecured Creditors v. Trism, Inc. (In re Trism, Inc.), 328 F.3d 1003 (8th Cir. 2003) 19

Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.), 596 F.2d 1092 (2d Cir. 1979) 11, 16

Cited Authorities

Page

Paulman v. Gateway Venture Partners III, LP (In re Filtercorp, Inc.), 163 F.3d 570 (9th Cir. 1998) 18

In re Payless Cashways, Inc., 268 B.R. 543 (Bankr. W.D. Mo. 2001) 3

In re Qualitech Steel Corp., 276 F.3d 245 (7th Cir. 2001) 27

Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992) 10, 14, 15, 21

Sulmeyer v. Karbach Enters. (In re Exennium, Inc.), 715 F.2d 1401 (9th Cir. 1983) 19

Term Loan Holder Comm. v. Ozer Group LLC (In re Caldor Corp.), 303 F.3d 161 (2d Cir. 2002) ... 6

The Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.), 16 F.3d 552 (3d Cir. 1994) 11, 16, 17

Tompkins v. Frey (In re Bel Air Assocs., Ltd.), 706 F.2d 301 (10th Cir. 1983) 19

Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co.), 834 F.2d 599 (6th Cir. 1987) ..... *passim*

DOCKETED CASES

Kmart Corp. v. Irving Paper, Inc., Adv. Case No. 04A00129 (Bankr. N.D. Ill.) 8

Cited Authorities

Page

FEDERAL STATUTES

11 U.S.C. § 363(b) 17

11 U.S.C. § 363(c) 17

11 U.S.C. § 363(m) ..... *passim*

11 U.S.C. § 364 ..... *passim*

11 U.S.C. § 364(a) ..... *passim*

11 U.S.C. § 364(b) ..... *passim*

11 U.S.C. § 364(c) 3, 26, 27

11 U.S.C. § 364(d) 3, 27

11 U.S.C. § 364(e) ..... *passim*

11 U.S.C. § 366 29

11 U.S.C. § 503(b)(1) 3

11 U.S.C. § 507(a)(1) 3

11 U.S.C. § 549 8

11 U.S.C. § 549(a)(2)(B) 8

11 U.S.C. § 550 8

11 U.S.C. § 1101(1) 2

11 U.S.C. § 1104 2

11 U.S.C. § 1107(a) 2

28 U.S.C. § 1254(1) 1

Cited Authorities

Page

RULES

Fed. R. Bankr. P. 4004 17

Fed. R. Bankr. P. 4007 17

MISCELLANEOUS

3 *Collier on Bankruptcy*, ¶ 364.02 (15th ed. rev. 2003) 2

3 *Collier on Bankruptcy*, ¶ 364.02[2][b] (15th ed. rev. 2003) 3

3 *Collier on Bankruptcy*, ¶ 364.02[2][c] (15th ed. rev. 2003) 16

3 *Collier on Bankruptcy*, ¶ 364.06 (15th ed. rev. 2003) 17

3 *Collier on Bankruptcy*, ¶ 364.06[1] (15th ed. rev. 2003) 18

5 *Collier on Bankruptcy*, ¶ 549.04[3] (15th ed. rev. 2003) 8

5 *Collier on Bankruptcy*, ¶ 549.04[4] (15th ed. rev. 2003) 8

H.R. Rep. No. 595, 95th Cong., 2nd Sess. 347, *reprinted in* 1978 U.S.C.C.A.N. 5987, 6303 ..... 18, 23

TABLE OF APPENDICES

Page

Appendix A – Opinion Of The United States Court Of Appeals For The Seventh Circuit Decided February 24, 2004 ..... 1a

Appendix B – Memorandum Opinion Of The United States District Court For The Northern District Of Illinois, Eastern Division Dated April 10, 2003 ..... 15a

Appendix C – Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors Of The United States Bankruptcy Court For The Northern District Of Illinois, Eastern Division Dated January 25, 2002 ..... 29a

Appendix D – Notice Of Appeal From Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors Of The United States Bankruptcy Court For The Northern District Of Illinois, Eastern Diision Dated February 1, 2002 ..... 36a

Appendix E – Order Of The United States Court Of Appeals For The Seventh Circuit Denying Petition For Rehearing Dated May 6, 2004 ..... 43a

Appendix F – Excerpts From Motion For Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors 45a

Appendix G – Excerpts From Affidavit And Statement Of Charles C. Conaway In Support Of Chapter 11 Petitions And First Day Orders Filed January 25, 2002 ..... 64a

Appendices

Page

Appendix H – Complaint To Avoid Transfer Of Property And For Recovery Dated January 22, 2004 And Filed January 26, 2004 ..... 73a

Appendix I – Excerpts From Transcript Of Proceedings Dated January 22, 2002 ..... 79a

Appendix J – Excerpts From Tape Transcription Dated January 22, 2004 ..... 86a

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit (Pet. App. 1a) is published at 359 F.3d 866. The court of appeals' order denying the petition for rehearing and rehearing *en banc* (Pet. App. 43a) is unpublished. The opinion of the United States District Court for the Northern District of Illinois (Pet. App. 15a) is unpublished. The order of the United States Bankruptcy Court for the Northern District of Illinois (Pet. App. 29a) is unpublished.

JURISDICTION

The court of appeals entered its judgment on February 24, 2004. A petition for rehearing and rehearing *en banc* was timely filed on March 9, 2004. The court of appeals denied the petition on May 6, 2004. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

RELEVANT STATUTORY PROVISIONS

Section 364(a) of the Bankruptcy Code, 11 U.S.C. § 364(a), provides in relevant part:

> [U]nless the [bankruptcy] court orders otherwise, [a chapter 11 debtor] may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

Section 364(b) of the Bankruptcy Code, 11 U.S.C. § 364(b), provides:

> The [bankruptcy] court, after notice and a hearing, may authorize [a chapter 11 debtor] to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

Section 364(e) of the Bankruptcy Code, 11 U.S.C. § 364(e), provides:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any

> debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority, were stayed pending appeal.

STATEMENT

This case arises out of the chapter 11 bankruptcy proceedings of Kmart Corporation ("Kmart"). When a debtor such as Kmart files for bankruptcy, it often requires immediate access to credit in order to continue its operations. Recognizing this business reality, section 364 of the Bankruptcy Code broadly authorizes a chapter 11 debtor to "obtain credit or incur debt," and this authorization includes obtaining credit from trade vendors who supply the debtor with necessary goods and services. *See Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 12 (2000).

Specifically, section 364(a) authorizes the debtor to obtain credit or incur debt "in the ordinary course of business." 11 U.S.C. § 364(a).[1] Pursuant to this provision, a debtor may obtain goods and services on credit without prior court approval if the goods and services are those that the debtor typically would purchase to conduct its usual and customary operations. Goods and services falling within the scope of section 364(a) would include items or supplies that a debtor such as Kmart normally sells in its stores or consumes in the

1. Section 364(a) expressly authorizes a "trustee" to obtain credit or incur debt. In a chapter 11 case, however, a trustee typically is not appointed. Instead, the debtor remains in control of its assets and operations as the "debtor in possession" and enjoys the powers of a trustee. *See* 11 U.S.C. § 1101(1) (defining "debtor in possession" to mean the debtor in a chapter 11 case); § 1104 (providing for the appointment of a trustee under limited circumstances); § 1107(a) (providing that the debtor as "debtor in possession" is granted the rights and powers of a trustee). Accordingly, the term "trustee" as used in section 364 includes a chapter 11 debtor in possession such as Kmart. *See Hartford Underwriters*, 530 U.S. at 6 n.3 (observing that a debtor in possession in a chapter 11 case is "expressly given the rights and powers of a trustee by 11 U.S.C. § 1107."); 3 *Collier on Bankruptcy*, ¶ 364.02 at 364-4 (15th ed. rev. 2002) (observing that, pursuant to section 1107, a debtor in possession may obtain credit under section 364).

ordinary course of its retailing operations. *See Credit Alliance Corp. v. Idaho Asphalt Supply, Inc. (In re Blumer)*, 95 B.R. 143, 147-48 (B.A.P. 9th Cir. 1988) (after filing for bankruptcy, debtor engaged in road building business could obtain asphalt on credit in the ordinary course of business under section 364(a) without prior court approval).

Similarly, section 364(b) authorizes the debtor to obtain credit or incur debt other than in the ordinary course of business, provided that the bankruptcy court first approves the transaction after notice and a hearing. Under this provision, a debtor, with court approval, may purchase on credit goods and services that it does not customarily use in its operations, or purchase goods and services on credit terms that are not usual and customary. *See In re Payless Cashways, Inc.*, 268 B.R. 543, 546-47 (Bankr. W.D. Mo. 2001) (after filing for bankruptcy, debtor engaged in sale of lumber could obtain necessary supplies on credit other than in the ordinary course of business where the credit terms included the debtor's payment of the suppliers' preexisting invoices).

Sections 364(a) and (b) each authorize the treatment of the cost of credit as an expense of administration entitled to priority payment under section 503(b)(1) of the Code. 11 U.S.C. §§ 364(a), (b). *See also* 11 U.S.C. § 507(a)(1) (providing for the priority payment of administrative expenses). In addition, sections 364(c) and (d) authorize the debtor to grant superpriority status, or to pledge collateral, to secure an extension of credit if certain conditions are satisfied. 11 U.S.C. §§ 364(c), (d). *See Hartford Underwriters*, 530 U.S. at 12 (explaining that trade creditors who provide goods or services to the debtor on credit may "obtain superpriority under § 364(c)(1) or a security interest under §§ 364(c)(2), (3), or § 364(d)" to secure their post-petition extensions of credit).[2]

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2. The term "superpriority" refers to administrative priority ahead of ordinary administrative priority. Secured creditors are generally paid from their collateral ahead of all administrative claimants, including those granted superpriority. *See Hartford Underwriters*, 530 U.S. at 5 (observing that "[a]dministrative expenses . . . do not have priority over secured claims"); 3 *Collier*, ¶ 364.04[2][b] at 364-12-13 (discussing superpriority and secured credit transactions under section 364).

In turn, section 364(e) expressly protects the creditor who has extended credit under either section 364(a) or (b) from having its credit transaction overturned on appeal. Specifically, section 364(e) provides that "[t]he reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted," provided that the creditor extended the credit in good faith and the party objecting to the credit transaction did not obtain a stay of the transaction pending appeal. 11 U.S.C. § 364(e). Section 364(e) is vitally important for creditors and debtors in bankruptcy because it assures that the parties may, in reliance upon its protections, act immediately to consummate their credit agreement free from appellate uncertainty, thus facilitating necessary credit transactions. *See Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1489 (9th Cir. 1987) ("[T]he purpose of section 364(e) was to overcome a good faith lender's reluctance to extend financing in a bankruptcy context by permitting reliance on a bankruptcy judge's authorization.").

After filing its bankruptcy case, Kmart required shipments of paper from petitioner Irving Pulp & Paper, Limited ("Irving") to print its advertising circulars. The circulars are critically important to Kmart's business because Kmart estimates that the circulars generate over 30% of its sales volume. (Pet. App. 51a; 70a). At the time Kmart filed for bankruptcy, however, many of its suppliers (including Irving) were reluctant to ship goods to Kmart on credit given Kmart's bankruptcy status and its failure to pay the pre-petition invoices of many of its vendors (including Irving's pre-petition invoice of approximately $3.5 million).[3] To overcome this reluctance and normalize its business relationships with its critical trade suppliers, Kmart filed a motion with the bankruptcy court seeking approval of a form of credit transaction that would allow

3. The term "pre-petition" refers to claims, events, or transactions that arise before a debtor files a petition commencing a bankruptcy case. In turn, the term "post-petition" refers to claims, events, or transactions that arise after the debtor files a petition commencing its bankruptcy case.

Kmart to obtain ongoing shipments of goods on credit in a manner satisfactory to both Kmart and its vendors. (Pet. App. 45a). On January 25, 2002, after notice and a hearing, the bankruptcy court approved Kmart's proposed form of credit transaction and entered an order accordingly (the "Vendor Order" or "Order," Pet. App. 29a).

The Vendor Order expressly authorized Kmart to pay the relevant supplier's outstanding pre-petition invoice as an administrative expense, provided that the supplier agreed to ship goods to Kmart on ordinary credit terms for a two-year period. (Pet. App. 29a-32a). Under the terms of the Vendor Order, the supplier also had to agree to waive any lien or reclamation rights that it had with regard to any goods shipped. (Pet. App. 32a).[4] The Vendor Order thus provided Kmart with the certainty that critical suppliers who agreed to the terms of the Order would ship necessary items on ordinary credit terms for an extended period. The Order likewise provided the critical vendors with the certainty that their pre- and post-petition claims for shipped goods would be paid on a priority basis.

After the bankruptcy court entered the Vendor Order, Irving agreed to the provisions of the Order and commenced shipping tens of millions of dollars worth of goods to Kmart on favorable credit terms. In turn, Kmart paid Irving's pre-petition invoice in the amount of approximately $3.5 million as an expense of administration and thereafter Kmart paid Irving for its post-petition shipments. In addition, Irving relinquished any lien or reclamation rights that it had with regard to the goods that it had shipped.

Kmart's agreement to treat Irving's pre-petition invoice as a priority expense of administration provided a significant inducement to Irving to extend post-petition credit to Kmart. Without the priority treatment, Irving's pre-petition claim would have merely constituted a general unsecured claim against Kmart's bankruptcy estate (putting aside Irving's lien and reclamation rights, if any, applicable

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4. For a discussion of reclamation rights asserted in the Kmart case, *see* Pet. App. 70a-72a.

to a portion of its claim). In the vast majority of chapter 11 cases, general unsecured creditors recover only a fraction of the face amount of their claims, and Kmart's bankruptcy is typical in this regard. With priority treatment, however, Irving stood a far better chance of being paid in full.[5]

The Vendor Order authorized a common type of bankruptcy credit transaction. In many chapter 11 cases, the debtor cannot reorganize without shipments of necessary goods and services on credit, and would prefer to obtain essential supplies on the most favorable credit terms available. It is common practice that, in exchange for a vendor's agreement to ship goods on ordinary credit terms (e.g., credit terms that the vendor would provide to financially healthy firms), the debtor agrees, with bankruptcy-court approval, to pay the vendor's outstanding pre-petition invoice. Indeed, as counsel for respondent observed in the bankruptcy court in this case, this kind of transaction is "done all over." (Pet. App. 85a).

On February 1, 2002, without notifying Irving and without seeking or obtaining a stay of the Vendor Order, respondent Capital Factors, Inc. ("Capital") appealed the Vendor Order to the district court. Over a year later, on April 8, 2003, the district court reversed the Vendor Order – again without notice to Irving. In reversing the Vendor Order, the district court concluded that the form of credit transaction approved in the Order – in particular, the payment of the

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5. Conferring administrative expense status on a supplier's pre-petition claim, while beneficial, does not assure payment in full. In some chapter 11 cases, the debtor is unable to pay all of its administrative expenses in full because it lacks the funds to do so. In such cases, the debtor is "administratively insolvent." An example is the chapter 11 bankruptcy case of the Caldor chain of retail stores. *See Term Loan Holder Comm. v. Ozer Group, LLC (In re Caldor Corp.)*, 303 F.3d 161, 164 (2d Cir. 2002) (noting administrative insolvency of debtor). Accordingly, conferring administrative expense status simply reduces the risk of non-payment. *See General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73, 75 (2d Cir. 1984) ("Under the law as it presently exists, knowledgeable bankruptcy attorneys must be aware that the priority ordinarily given to administration expenses may prove illusive" if the claims of more senior creditors exhaust the debtor's assets.) (quotations omitted).

critical suppliers' pre-petition invoices in exchange for their agreement to extend credit post-petition – was erroneous. (Pet. App. 23a). Thereafter, Irving intervened in the district court and appealed the district court's order to the Seventh Circuit Court of Appeals.

Irving argued in the Seventh Circuit that sections 364(a) and (b) authorized the credit transaction set forth in the Vendor Order, including the payment of Irving's pre-petition invoices as part of the cost of credit. (*See Brief of Appellant Irving Pulp & Paper, Limited d/b/a Irving Paper*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 8-14). Irving also argued that, pursuant to section 364(e), it was entitled to the benefit of the Vendor Order because Irving had extended credit to Kmart in good faith and Capital did not seek or obtain a stay of the order pending appeal. (*Id.* at 26-28). Rejecting both arguments (as well as the arguments advanced by other appellants), the Seventh Circuit affirmed the district court's order.

In reaching its conclusion, the Seventh Circuit acknowledged that section 364(e) does "forbid revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court concluded that nothing in the Bankruptcy Code "covers payments made to pre-existing, unsecured creditors" such as Irving whose pre-petition invoices were paid in accordance with the Vendor Order as part of their agreement to provide post-petition credit to Kmart. (Pet. App. 4a). The court also recognized that section 364(b) "authorizes the debtor to obtain credit (as Kmart did)," but concluded that this authority does not extend to the payment of a supplier's pre-petition invoices as part of a post-petition credit transaction. (Pet. App. 9a).

In affirming the district court, the Seventh Circuit recognized that the critical suppliers such as Irving had fulfilled their end of the bargain by extending credit to Kmart under the terms of the Vendor Order. (Pet. App. 5a) ("[A]fter the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts)."). The court also acknowledged that, with the Vendor

Order reversed, Kmart could and would proceed to recover all the payments that Kmart had made to suppliers on account of their pre-petition invoices, even though these payments had been a part of the credit terms. The court concluded: "If the [Vendor Order is] invalid, then the critical vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors." (Pet. App. 3a-4a).

Indeed, following the district court's reversal of the Vendor Order, Kmart began suing its critical suppliers to recover the payments that Kmart had made to them on account of their pre-petition invoices. Since the Seventh Circuit's ruling, Kmart has pursued literally thousands of lawsuits to recover hundreds of millions of dollars from suppliers whose pre-petition invoices Kmart paid under the terms of the Vendor Order. Most of these lawsuits remain pending and will take years to resolve. Among the pending suits, Kmart has specifically sought to recover the approximately $3.5 million that it paid to Irving on account of Irving's pre-petition invoices. *See Kmart Corp. v. Irving Paper, Inc.*, Adv. Case No. 04A00129 (Bankr. N.D. Ill.) (Pet. App. 73a). Kmart contends that, now that the Vendor Order has been overturned, Kmart's payment of Irving's pre-petition invoices was not "authorized" and, therefore, may be set aside and recovered as an unauthorized post-petition transfer under sections 549 and 550 of the Bankruptcy Code. (Pet. App. 76a). It is clear that, but for the district court's reversal of the Vendor Order, Kmart would not be able to recover these payments because section 549 only permits the avoidance of *unauthorized* post-petition transactions, not those the bankruptcy court approved. *See* 11 U.S.C. § 549(a)(2)(B) (providing that "the trustee may avoid a transfer of property of the estate . . . that is not authorized under this title or by the court."); 5 *Collier on Bankruptcy*, ¶ 549.04[3] at 549-10 (15th ed. rev. 2003) ("Section 549 provides that transfers made under the authority of the Code are not voidable"); *id.*, ¶ 549.04[4] at 549-11 ("Transfers authorized by the bankruptcy court . . . would also not be within the avoiding powers. . . .").

REASONS FOR GRANTING THE PETITION

The circuits are intractably divided in a three-way split over whether and to what extent section 364(e) of the Bankruptcy Code protects a court-approved credit transaction from subsequent appellate reversal or modification. Given the importance of credit transactions in chapter 11 proceedings (which are necessary in virtually all of the thousands of chapter 11 cases that are filed each year and which can easily amount to billions of dollars in a single case, as the Kmart bankruptcy itself illustrates), the conflict among the courts, and the uncertainty that it creates, is untenable. This case presents an ideal vehicle to resolve this split of authority because the issue is presented simply and clearly in the context of a common and recurring type of bankruptcy credit transaction. Further, resolution here of the question presented is outcome-determinative. Certiorari is also warranted because the Seventh Circuit's decision is wrong on the merits.

I. The Courts of Appeals Are Intractably Divided Into Three Camps Over the Question Presented and Review in this Court is Necessary and Warranted To Resolve the Conflict.

Under section 364(e), a creditor is entitled to the benefit of a bankruptcy court's order approving the terms of a credit transaction, so long as the creditor extends credit in good faith and no party has obtained a stay of the order approving the transaction. 11 U.S.C. § 364(e). The Sixth and Ninth Circuits have concluded that section 364(e) protects from appellate reversal a court-approved credit transaction that includes the priority treatment of a creditor's pre-petition claim as part of the terms of the transaction. *See In re Adams Apple*, 829 F.2d at 1488 ("We therefore conclude that section 364(e) is meant to protect the lender by preventing reversal of a [court-approved credit term requiring the priority treatment of the lender's pre-petition claim in exchange for the lender's post-petition extension of credit] unless a stay is obtained pending appeal."); *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanoba (In re Ellingsen MacLean Oil Co.)*, 834 F.2d 599, 604 (6th Cir. 1987) ("[W]e conclude that the amended order

[establishing the priority treatment of the post-petition lender's pre-petition claim by prohibiting any challenge to the validity of the pre-petition liens securing the claim] should also be deemed to be protected by the provisions of section 364(e)."); *see also Boullioun Aircraft Holding Co., Inc. v. Smith Mgmt. (In re Western Pacific Airlines, Inc.)*, 181 F.3d 1191, 1196 (10th Cir. 1999) (following the Ninth Circuit's approach in *Adams Apple* and concluding that "[W]e read § 364(e) to apply not just to the validity of financing itself, but also to the terms"); *New York Life Ins. Co. v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 901 F.2d 1359, 1364 (6th Cir. 1990) (same).[6]

In contrast, the Eleventh Circuit, now joined by the Seventh Circuit, has concluded that section 364(e) does not provide such protection. *See In re Kmart Corp.*, 359 F.3d 866, 869 (7th Cir. 2004) (concluding that section 364(e) does not "cover[] payments made to pre-existing, unsecured creditors" as part of a court-approved credit transaction); *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1493 (11th Cir. 1992) (stating that "[w]e reject the reasoning of *In re Adams Apple* and *In re Ellingsen*" and holding that a credit term requiring the priority treatment of a lender's pre-petition claim in exchange for the lender's post-petition extension of credit is not protected by section 364(e)).[7] In addition, the Second Circuit has concluded that, although the bankruptcy court has the jurisdictional "authority" to approve a credit transaction that includes the priority treatment of the creditor's pre-petition claim, an appellate court may reverse the bankruptcy court's authorization if certain procedural requirements are

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6. In its brief filed in the Seventh Circuit, Irving relied on, among other cases, the Ninth Circuit's decision in *Adams Apple* and the Tenth Circuit's decision in *Western Pacific* in making its argument under section 364(e). (*See Brief of Appellant Irving Pulp & Paper, Limited d/b/a Irving Paper*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 26-28; *see also Brief for Amicus Curiae Submitted by Meridian Retail, Inc.*, at 13-15 (citing *Adams Apple* and *Ellingsen*)).

7. In opposing Irving's argument under section 364(e), Capital relied on the Eleventh Circuit's decision in *Saybrook*. (*See Brief of Appellee Capital Factors, Inc.*, filed in case nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, & 03-2348 (consolidated) at 93-94).

not satisfied. *See Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F.2d 1092, 1198, 1100 (2d Cir. 1979) (in reversing financing order, court noted that, for jurisdictional purposes, "[t]he financing order was within the parameters of the bankruptcy court's authority," but concluded that it "should not have been granted by an ex parte order" entered "solely on representations by a debtor in possession").

In turn, the Third Circuit has adopted yet another approach in applying section 364(e). *See The Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)*, 16 F.3d 552, 562 (3d Cir. 1994) ("As we already have set forth, in our view section 364(e) does not preclude a court from reversing an authorization absent a stay" and applying an approach distinct from that of the other circuits).

Review by this Court is necessary and warranted to resolve the conflict among the courts of appeals over the proper application of section 364(e) because the circuit courts have embraced diametrically opposed views; the conflict is irreconcilable and has existed for a prolonged period; the disagreement is unlikely to diminish with the passage of time; the conflict extends across a number of appellate decisions; all of the relevant issues have been fully vetted in the lower courts; and the conflict is unlikely to be resolved in the courts below through resort to *en banc* procedure. Indeed, the Seventh Circuit refused to review *en banc* the question presented in this case, as did the Sixth Circuit in *Ellingsen*.

Moreover, this case presents an ideal vehicle to resolve the conflict among the circuits because resolution of the question presented is outcome-determinative. Likewise, this case presents a clear basis for resolution of the conflict in the context of the type of bankruptcy credit transaction responsible for the division among the courts of appeals over the proper application of section 364(e) — namely, the priority treatment of a creditor's pre-petition claim as part of the parties' post-petition credit terms. In addition, because the form of credit transaction in this case is exceedingly common, the issue of an appellate court's ability to review the transaction under section 364(e) will recur again and again. Accordingly, certiorari is warranted.

A. Review Is Warranted Because the Courts of Appeals Are Divided over the Question Presented.

As noted, the Ninth and Sixth Circuits have concluded that section 364(e) protects from appellate reversal or modification a court-approved credit transaction that includes the priority treatment of the creditor's pre-petition claim as part of the credit terms. *See In re Adams Apple*, 829 F.2d at 1488; *In re Ellingsen MacLean Oil*, 834 F.2d at 604; *see also In re Western Pacific Airlines*, 181 F.3d at 1196 (following *Adams Apple*); *In re Revco D.S.*, 901 F.2d at 1364 (following *Adams Apple* and *Ellingsen*); *Bank of New England v. BWL, Inc.*, 121 B.R. 413, 416-18 (D. Me. 1990) (following *Adams Apple*).

In *Adams Apple*, the debtor moved the bankruptcy court for approval of a post-petition credit transaction involving the creditor's agreement to extend post-petition credit to the debtor in exchange for the debtor's treatment of the creditor's pre-petition claim on a priority basis as part of the credit terms. Prior to its bankruptcy filing, the debtor owed the creditor an unsecured debt of $450,000. After the debtor filed for bankruptcy, the creditor agreed to extend additional credit, provided that the debtor agreed to treat the $450,000 pre-petition debt as entitled to priority status on a secured basis under section 364. As noted in the court's opinion, the practice of elevating a pre-petition debt to post-petition priority status in exchange for new credit is known colloquially as "cross-collateralization." *Adams Apple*, 829 F.2d at 1486 n.1.

After the bankruptcy court approved the credit transaction, a group of creditors appealed – first to the district court (which rejected the appeal), and then to the Ninth Circuit. Relying on section 364(e), the Ninth Circuit observed that "[a]n appellate court may not reverse the authorization to obtain credit or incur debts under section 364 if the authorization was not stayed pending appeal unless the lender did not act in good faith." 829 F.2d at 1487-88. Recognizing that "[s]ection 364 authorizes a bankruptcy court to permit the use of a variety of financing devices," the court considered whether the practice of elevating a creditor's pre-petition claim to priority status in exchange for post-petition credit was such a device. Although the court observed that the text of section

364 "does not indicate whether Congress intended to include a device that permits a creditor to promote his pre-petition debt" to priority status, the court stated that the practice "appear[s] to be covered by section 364, and in turn subject to section 364(e)." *Id.* at 1488. Moreover, the Ninth Circuit determined that, even if the bankruptcy court's order approving the transaction was erroneous because the transaction did not involve a legitimate financing term, the creditor was still entitled to the protection of section 364(e) so long as the creditor extended credit in good faith and the objecting party failed to obtain a stay of the bankruptcy court's order. 829 F.2d at 1488 n.6 ("Because the bankruptcy judge thought that cross-collateralization was legal and entered an order to that effect upon which the creditor relied, we conclude that the creditor should receive the protection of section 364(e) in this case."). The court held: "[w]e therefore conclude that section 364(e) . . . protect[s] the lender by preventing reversal of a cross-collateralization clause unless a stay is obtained pending appeal." *Id.* at 1488.

In applying section 364(e), the Ninth Circuit reasoned that "[s]ection 364 was designed to provide a debtor a means to obtain credit after filing bankruptcy." *In re Adams Apple*, 829 F.2d at 1488. The court further observed that "[a] lender may be willing to extend credit if the arrangement includes a cross-collateralization clause, . . . but would withhold credit if the clause could be overturned on appeal." *Id.* Rejecting the argument that section 364(e) did not apply because the lender "has not 'relied' on a bankruptcy court's authorization if the lender has recouped fully its post-petition outlay," the court stated that, without the added compensation afforded by the priority treatment of the creditor's pre-petition claim, "lenders may choose to invest in other enterprises." *Id.* As a result, the "[c]ongressional intent of fostering private investment in failing companies by promoting reliance on a bankruptcy court's authorization would be defeated." *Id.*

In *Ellingsen*, the debtor similarly moved the bankruptcy court for approval of a post-petition credit transaction involving the creditor's agreement to extend post-petition credit in exchange for the debtor's agreement to forego any

challenge to the creditor's pre-petition liens securing the creditor's pre-petition claim. After the bankruptcy court approved the credit transaction, a group of creditors appealed — first to the district court (which dismissed the appeal under section 364(e)), and then to the Sixth Circuit.

Recognizing that the debtor's agreement to forego any challenge to the creditor's pre-petition liens was "part of the whole 'package' [of credit terms that the bankruptcy court] authorized under section 364," the court considered whether the statute permitted this type of financing arrangement for purposes of section 364(e). *Ellingsen*, 834 F.2d at 602. Determining that it might, the court concluded that the bankruptcy court's authorization of the transaction "does not exceed section 364(e)'s protection." *Id.* at 604. The court added: "'The proper recourse for the objecting creditor is to get the transaction stayed pending appeal.'" *Id.* at 604-05 (quoting *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982)). Like the Ninth Circuit, the Sixth Circuit determined that, even if the bankruptcy court's order was arguably in error, the creditor was still entitled to the protection of section 364(e) so long as the creditor acted in good faith and the objecting party failed to obtain a stay. *Ellingsen*, 834 F.2d at 603 ("[T]he mere allowance of cross-collateralization in some degree as a financing tool should not categorically deprive an order of section 364(e) protection. More important than the nature of the advantage given the [b]anks for extending further credit is the fact that unsecured creditors failed to obtain a stay.").

In contrast, the Eleventh Circuit — now joined by the Seventh Circuit in the decision below, *see In re Kmart*, 359 F.3d at 869 — has concluded that section 364(e) does not protect a court-approved credit transaction that includes the priority treatment of the creditor's pre-petition claim as part of the credit terms. *See In re Saybrook Mfg. Co.*, 963 F.2d at 1493.

In *Saybrook*, the debtor moved the bankruptcy court to approve a credit transaction involving a creditor's agreement to extend post-petition credit to the debtor in exchange for the debtor's agreement to treat the creditor's pre-petition unsecured claim as entitled to priority on a secured basis.

The bankruptcy court approved the transaction, and two unsecured creditors appealed – first to the district court (which dismissed the appeal under section 364(e)), and then to the Eleventh Circuit.

After discussing the Ninth Circuit's decision in *Adams Apple* and the Sixth Circuit's decision in *Ellingsen*, the Eleventh Circuit rejected the holdings and reasoning of these cases. *Saybrook*, 963 F.2d at 1493. Acknowledging that credit transactions involving the priority treatment of a creditor's pre-petition claim in exchange for post-petition credit is a common practice, the court nevertheless stated that it is a "controversial form of Chapter 11 financing." *Id.* Canvassing various decisions discussing the practice, the court determined that "[c]ross-collateralization is not authorized by section 364." *Id.* at 1495. Concluding on the merits that the bankruptcy court's order was thus erroneous, the Eleventh Circuit held that "[s]ection 364(e), therefore, is not applicable." *Id.* at 1496.

Mirroring the Eleventh Circuit's approach, the court below also concluded on the merits that section 364 does not permit a bankruptcy court to approve a credit transaction that includes the priority treatment of a creditor's pre-petition claim in exchange for the creditor's post-petition extension of credit. Like the Eleventh Circuit, the Seventh Circuit concluded that, because the transaction is not proper under section 364, section 364(e) affords no protection. *In re Kmart*, 359 F.3d at 869.

The approach taken by the Eleventh and Seventh Circuits in applying section 364(e) is diametrically opposed to that taken by the Ninth and Sixth Circuits. According to the Ninth and Sixth Circuits, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is a narrow one. In the absence of a stay of the order pending appeal, the appellate court will preserve the credit transaction for the benefit of the creditor, even if the bankruptcy court's approval of the transaction was erroneous, so long as the creditor extended credit in good faith. In other words, in the absence of a stay, the appellate court's ability to deny the creditor the benefit of its bargain is circumscribed by the bounds of the good-faith standard. The Tenth Circuit also

adheres to this approach in applying section 364(e). *See In re Western Pacific Airlines*, 181 F.3d at 1195 n.2, 1196; *see also In re Revco D.S.*, 901 F.2d at 1363-64 (subsequent panel of Sixth Circuit following *Ellingsen*).

In contrast, according to the Eleventh and Seventh Circuits, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is far broader. Under this approach, the appellate court may deny the creditor the benefit of its bargain, regardless of whether the appellant has sought or obtained a stay, if the appellate court concludes that the bankruptcy court should not have entered the order approving the transaction in the first place. In other words, notwithstanding section 364(e) and the appellant's failure to seek or obtain a stay, the appellate court's ability to deny the creditor the benefit of its bargain is coextensive with its ability to determine whether the bankruptcy court's order was erroneous for some reason *other* than lack of good faith. The Second Circuit also has followed this general approach. *See In re Texlon Corp.*, 596 F.2d at 1198; *see also In re Ellingsen*, 834 F.2d at 607 (Merritt, J., dissenting) (urging an approach similar to that taken by the Eleventh and Seventh Circuits); *In re Revco D.S.*, 901 F.2d at 1367 (Hull, J., dissenting) (same); 3 *Collier*, ¶ 364.04[2][c] at 364-14 (discussing *Saybrook* and noting conflict among the courts of appeals).

Adding further to the disarray in the decisional law, the Third Circuit takes still another approach under section 364(e). *See Swedeland*, 16 F.3d at 562 ("As we already have set forth, in our view section 364(e) does not preclude a court from reversing an authorization absent a stay. What it limits is the effect of a reversal."). Under the *Swedeland* analysis, the appellate court's task in reviewing a bankruptcy court's order approving the terms of a credit transaction is likewise not circumscribed solely by the creditor's good faith and the appellant's success in obtaining a stay. *See id.* (reviewing *Adams Apple*, *Revco*, and *Ellingsen*, and stating that "the courts in the above cases have not read section 364(e) as we did above"). Rather, even if the creditor acted in good faith and the appellant failed to obtain a stay, the appellate court may still modify the

bankruptcy court's order if the appellate court may do so without fundamentally impairing the validity of a fully consummated transaction. Applying this standard, the Third Circuit concluded in *Swedeland* that, because one of the transactions at issue had not yet been fully consummated, the court could still modify the bankruptcy court's order. With regard to a second transaction that had been fully consummated, however, the court concluded that it could not make any modification. *Id.* at 562-63. *See* 3 *Collier*, ¶ 364.06 at 364-22.1 (discussing split of authority between Third Circuit's approach in *Swedeland* and Sixth and Ninth Circuits' approach in *Revco* and *Adams Apple*).

In sum, the circuits are clearly divided on the question presented – whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification, and the decision of the court below plainly conflicts with decisions of the Third, Sixth, Ninth, and Tenth Circuits.

B. Review Is Further Warranted Because the Decision of the Court Below Conflicts with the Decisions of Other Courts of Appeals on the Proper Application of Section 363(m) of the Bankruptcy Code – a Provision Nearly Identical to Section 364(e).

The decision of the court below also conflicts irreconcilably with the decisions of *ten* other courts of appeals on the proper application of section 363(m) – a provision nearly identical to section 364(e). *See Kontrick v. Ryan*, __ U.S. __, 124 S. Ct. 906, 913 n.6 (2004) (explaining grant of certiorari to resolve conflict of authority on proper construction of Fed. R. Bankr. P. 4004, and citing decision interpreting nearly identical Rule 4007 as illustrating conflict).

In pertinent part, sections 363(b) and (c) of the Bankruptcy Code authorize a bankruptcy court to approve the sale of a debtor's assets. *See* 11 U.S.C. §§ 363(b), (c). In turn, section 363(m) – like section 364(e) – protects the transaction from subsequent appellate modification:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this

> section of a sale . . . of property does not affect the validity of a sale . . . under such authorization to an entity that purchased . . . such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale . . . were stayed pending appeal.

11 U.S.C. § 363(m). Significantly, Congress patterned 364(e) on section 363(m). *See* H.R. Rep. No. 595, 95th Cong., 2nd Sess. 347, *reprinted in* 1978 U.S.C.C.A.N. 5987, 6303 ("Subsection (e) [of section 364] provides the same protection for credit extenders pending an appeal of an authorization to incur debt as is provided under section 363(1) for purchasers: the credit is not affected on appeal by reversal of the authorization unless the authorization and the incurring of the debt were stayed pending appeal."); *see also* 3 *Collier*, ¶ 364.06[1] at 364-22.1 (Section 364(e) "is consistent with section 363(m), which provides similar protection to a buyer . . . of property of the estate in a section 363 transaction.").

In applying section 363(m), numerous courts of appeals have adopted the same approach taken by the Ninth and Sixth Circuits in applying section 364(e) and have refused to overturn a sale order – even an arguably erroneous one – if the purchaser acquired the property in good faith and the objecting party failed to obtain a stay. *See Ginther v. The Ginther Trusts (In re the Ginther Trusts)*, 238 F.3d 686, 688-89 (5th Cir. 2001) (applying section 363(m) and refusing to consider challenge to bankruptcy court's order where appellant failed to obtain a stay); *Development Co. of America v. Adamson Co. (In re Adamson Co.)*, 159 F.3d 896, 897-98 (4th Cir. 1998) (applying section 363(m) and refusing to overturn sale order in the absence of a stay and lack of good faith); *Paulman v. Gateway Venture Partners III, LP (In re Filtercorp, Inc.)*, 163 F.3d 570, 576-77 (9th Cir. 1998) (applying section 363(m) and stating "[w]hen a sale of assets is made to a good faith purchaser, it may not be modified or set aside unless the sale was stayed pending appeal"); *Licensing By Paolo v. Sinatra (In re Gucci)*, 126 F.3d 380, 389 (2d Cir. 1997) (stating in section 363(m) case that "[w]e cannot take any action that affects the judicially-authorized sale if the purchaser acted in good faith and no

stay was granted"); *Anheuser-Busch, Inc. v. Miller (In re Stadium Mgmt. Corp.)*, 895 F.2d 845, 847 (1st Cir. 1990) (applying section 363(m) and stating "[a]bsent a stay, the court must dismiss a pending appeal [of a sale order] as moot because the court has no remedy that it can fashion even if it would have determined the issues differently"); *Hicks v. Pearlstein (In re Magwood)*, 785 F.2d 1077, 1080 (D.C. Cir. 1986) (Edwards, Ginsburg, and Scalia, JJ.) (concluding that, under section 363(m), the court had no authority to overturn a sale order and stating that "a sale made to a good faith purchaser pursuant to section 363(b) or (c) of the Code . . . cannot be overturned on appeal unless the sale was stayed pending appeal"); *Sulmeyer v. Karbach Enters. (In re Exennium, Inc.)*, 715 F.2d 1401, 1404 (9th Cir. 1983) ("If appeal is sought without a stay, the courts cannot grant relief because they cannot overturn the sale."); *see also Tompkins v. Frey (In re Bel Air Assocs., Ltd.)*, 706 F.2d 301, 304-05 (10th Cir. 1983) ("[A] party appealing from an order which authorizes the sale of property of a debtor should obtain a stay of the order. Otherwise the property may be sold to a 'good faith purchaser,' removing the property from the jurisdiction of the courts and rendering moot the appeal from the order authorizing the sale.").

In addition, the Third and Eighth Circuits have applied an approach under section 363(m) that mirrors the Third Circuit's *Swedeland* standard under section 364(e). *See Official Comm. of Unsecured Creditors v. Trism, Inc. (In re Trism, Inc.)*, 328 F.3d 1003, 1006-07 (8th Cir. 2003) ("The language of section 363(m) moots any challenge to an order approving the sale of assets that satisfies two requirements: First, no party obtained a stay of the sale pending appeal. . . . Second, 'reversing or modifying the authorization to sell would affect the validity of the sale. . . .'") (quoting *Cincola v. Scharffenberger*, 248 F.3d 110, 122 (3d Cir. 2001)); *L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs., Inc.)*, 209 F.3d 291, 297-98 (3d Cir. 2000) (applying two-part standard under section 363(m)).

Given the close similarly between sections 364(e) and 363(m), together with the close similarity in the divergent approaches taken by the courts of appeals in applying these parallel statutory provisions, reference to circuit authority under section 363(m) serves to demonstrate further the extent

to which the decision of the court below conflicts with decisions of other courts of appeals. Certiorari is especially warranted to resolve the conflict, given that *all* of the courts of appeals have addressed the proper application of either section 364(e) or section 363(m) (or both), and given the extent of the three-way split of authority within the combined body of precedents.

C. Review Is Further Warranted Because the Conflict Will Not Resolve Itself Absent the Court's Intervention.

The conflicting approaches to the proper application of section 364(e) are irreconcilable. Absent review by this Court, the split of authority among the courts of appeals will not resolve itself. For example, the Ninth and Sixth Circuits have adhered to their positions on the question presented for over fifteen years. Similarly, the Eleventh Circuit has maintained its contrary approach for nearly as long, and, far from assisting in any resolution, the decision of the court below merely exacerbates the existing disagreement.

Although conflicts among the courts of appeals are sometimes resolved through *en banc* procedure, both the court below and the Sixth Circuit have declined to exercise *en banc* review on the question presented, thus ensuring that the disagreement will continue. In addition, the fact that the conflict over the question presented mirrors a larger, more general, conflict among the courts of appeals over the proper application of sections 364(e) and 363(m) further demonstrates the intractable nature of the conflict and the need for this Court's intervention. Finally, given the number of decisions that have addressed the relevant issues under section 364(e), together with the number of decisions that have addressed the same issues under section 363(m), no point would be served by awaiting additional opinions from the courts of appeals before this Court intercedes. Because the relevant issues have been fully aired, and because the conflict among the courts of appeals is deeply entrenched, certiorari should be granted.

D. This Case Presents an Ideal Vehicle for the Resolution of the Question Presented.

This case presents an ideal vehicle for resolution of the conflict among the courts of appeals over the question presented because the issue is presented simply and clearly and its resolution is outcome-determinative. In addition, this case presents an ideal vehicle to resolve the conflict among the circuits because it involves the very type of bankruptcy credit transaction responsible for the division among the courts of appeals over the proper application of section 364(e). Further, because the form of credit transaction in this case is exceedingly common, the issue of an appellate court's ability to review the transaction under section 364(e) will recur again and again.

In entering the Vendor Order, the bankruptcy court approved a credit transaction that included as one of its terms the treatment of Irving's pre-petition invoices as a priority obligation payable in Kmart's bankruptcy case as an expense of administration. After the bankruptcy court entered the Vendor Order, Irving agreed to the terms of the Order and shipped goods to Kmart on credit. In turn, Kmart paid Irving's pre-petition invoices as a priority expense.

In affirming the district court's reversal of the Vendor Order, the Seventh Circuit concluded that the protections of section 364(e) do not apply because the bankruptcy court's approval of the Vendor Order was erroneous. Specifically, the court concluded that the bankruptcy court erred in approving the Order because one of the key terms of the credit transaction – the treatment of the suppliers' pre-petition invoices as a priority obligation – was not appropriate. This determination falls squarely within the scope of the conflict of authority initiated by *Adams Apple* and *Saybrook*.

Irving contends that the Seventh Circuit misapplied section 364(e) because, regardless of whether the bankruptcy court's Vendor Order was erroneous, the Seventh Circuit could not overturn the Order for the reasons that it gave. Because Irving extended credit under the terms of the Vendor Order, an appellate court could only overturn the Order, consistent

with section 364(e), if Irving extended credit in bad faith or if Capital obtained a stay pending appeal. This is an argument that would have prevailed in the Third, Sixth, Ninth, and Tenth Circuits under existing decisional authority applying section 364(e), and likewise would have prevailed in the First, Third, Fourth, Fifth, Eighth, Ninth, Tenth, and D.C. Circuits under existing decisional authority applying section 363(m). There is no dispute that Capital failed to seek, let alone obtain, a stay pending appeal. In addition, there is no indication that Irving extended credit in bad faith. At no point in the proceedings below did Capital argue (much less demonstrate) that Irving acted in bad faith. On the contrary, Capital conceded at oral argument that the critical suppliers, including Irving, had done nothing untoward or underhanded in the case. (Pet. App. 86a) (in response to question regarding the arms'-length nature of the transactions with the vendors, counsel for Capital stated: "I don't mean to imply that there was any underhanded methods here at all.").

But even if Capital were to question Irving's good faith at this point, that would have no bearing on the resolution of the question presented because the court below did not rely on the issue of good faith in rendering its decision. Rather, the court simply concluded as a matter of law that the protections of section 364(e) do not apply because section 364 does not authorize an order approving a credit transaction that includes as one of its terms the treatment of a creditor's pre-petition claim as a priority obligation payable as an expense of administration. Whether the Seventh Circuit was correct in reaching this conclusion is an independent question of law over which there exists a conflict of authority among the courts of appeals. Accordingly, the question presented arises simply and clearly and is thus well-positioned for review in the context of a bankruptcy court's order approving a common credit transaction in chapter 11 cases.

The resolution of the question presented is also outcome-determinative. If Irving does not prevail on the question, it will lose the protection of the Vendor Order regardless of whether it extended credit in good faith. In contrast, if Irving prevails on the question under the approach taken by the Sixth,

Ninth, and Tenth Circuits, or the alternative approach taken by the Third Circuit, then it will retain the protection of the Vendor Order. If any issue of good faith remains, it may be addressed on remand.

II. The Conflict Among the Courts of Appeals is Untenable Given the Importance of the Question Presented.

Bankruptcy courts approve credit transactions in virtually every chapter 11 case, and Congress enacted section 364(e) to facilitate the immediate consummation of these transactions by enhancing the certainty that they would not be modified on appeal. The decision of the court below seriously erodes the protection and utility of section 364(e), and thus impacts tens of thousands (if not hundreds of thousands) of credit transactions in the bankruptcy context. Inevitably, creditors faced with the prospect of having their credit transactions undone on appeal *after* they have extended credit will be far less likely to do business with chapter 11 debtors. As a result, chapter 11 debtors will find it far more difficult to reorganize – a result demonstrably at odds with Congress' intent in enacting section 364(e) and chapter 11 as a whole. *See Bank of America v. 203 North LaSalle St. P'ship*, 526 U.S. 434, 453 (1999) (recognizing goal of chapter 11 of "preserving going concerns"); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1983) ("the policy of Chapter 11 is to permit successful rehabilitation of debtors"); *In re Adams Apple*, 829 F.2d at 1489 (discussing section 364(e)'s purpose of facilitating lending in chapter 11); H.R. Rep. No. 595, 95th Cong., 2nd Sess. 347, *reprinted in* 1978 U.S.C.C.A.N. 5987, 6303 (discussing role of section 364(e) in facilitating lending).

This case also well illustrates the enormous burden, uncertainty, and inequity that the decision of the court below has placed on the administration of chapter 11 proceedings. In the Kmart case alone, *thousands* of trade creditors extended *billions* of dollars in post-petition trade credit to Kmart on the strength of the Vendor Order. In turn, after the Seventh Circuit affirmed the district court's reversal of the Vendor Order, Kmart has pursued *thousands* of lawsuits seeking to recover hundreds of millions of dollars representing Kmart's payment

of the pre-petition invoices of these suppliers. This is precisely the inequity, instability, and waste of resources that section 364(e) is intended to avoid.

Chapter 11 cannot operate as Congress intended with these burdens in place. The decision below has swamped the bankruptcy court's docket with thousands of pending lawsuits and seriously burdened the administration of Kmart's bankruptcy case. Not surprisingly, large corporate debtors in need of reorganization and with a choice of venue have avoided commencing their cases within the Seventh Circuit. Because the decision below affects innumerable credit transactions in thousands of chapter 11 cases, and puts billions of dollars in credit financing at risk, certiorari is warranted.

III. Certiorari Is Also Warranted Because the Decision of the Court Below Is Wrong on the Merits.

As this Court has instructed repeatedly, the starting point in construing the Bankruptcy Code is the text of the statute itself. *See Lamie v. United States Trustee*, __ U.S. __, 124 S. Ct. 1023, 1030 (2004) ("The starting point in discerning congressional intent is the existing statutory text"). In this case, section 364(e) plainly provides that Irving is entitled to the benefit of the Vendor Order unless Irving extended credit in bad faith or Capital obtained a stay pending appeal. Because the statute is plain and unambiguous, the court below should have looked no further than the governing text. *See Hartford Underwriters*, 530 U.S. at 6 ("[W]hen the statute's language is plain, the sole function of the courts . . . is to enforce it according to its terms.") (internal quotation marks and citations omitted); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 254 (1992) (same).

In this case, the court below acknowledged that section 364(e) "forbid[s] revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court concluded that the Bankruptcy Code does not authorize a credit transaction that includes as part of its terms the payment of the creditor's pre-petition claim and, thus, that Kmart could recover the payments that it made to its suppliers on account of their pre-petition invoices. (Pet. App. 3a-4a). The court's

acknowledgement that section 364(e) forbids appellate revision of court-approved credit transactions, however, should have ended the matter in view of Capital's failure to obtain a stay and the absence of any indication that Irving extended credit in bad faith.

A critical flaw in the Seventh Circuit's decision lies in its methodology. Instead of beginning with the text of section 364, the court commenced its analysis by considering whether it makes sense as a theoretical matter to allow a bankruptcy court to approve a credit transaction in which the debtor agrees to pay the creditor's pre-petition invoice as part of the terms of the creditor's post-petition extension of credit. (Pet. App. 1a-2a). The court reasoned that, if it did not make sense to allow this type of credit transaction, then Kmart is entitled to recover whatever amounts it had paid to the suppliers on account of their pre-petition invoices, even though the suppliers had already extended credit on the strength of the Vendor Order. (Pet. App. 3a-4a) ("If the orders in question are invalid, then the critical vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors."). Respectfully, the Seventh Circuit's method of addressing the soundness of the credit transactions at issue and announcing Kmart's remedy before considering its authority under section 364(e) is wrong. The proper method is that embraced by the Sixth, Ninth, and Tenth Circuits, which properly recognizes that the ability of an appellate court to deny a creditor the benefit of a court-approved credit transaction is circumscribed by the standard of good faith and whether the party objecting to the transaction obtained a stay pending appeal.

The Seventh Circuit also is wrong in its conclusion that permitting credit transactions of the kind at issue here is inappropriate under the Bankruptcy Code. In this case, the Vendor Order authorized Kmart to enter into a post-petition credit transaction with Irving that allowed Kmart to purchase goods post-petition on credit on certain enumerated terms. Under the express provisions of the Vendor Order, the payment of Irving's outstanding pre-petition claim was simply part of the price that Kmart agreed to pay for Irving's extension of

credit, including Irving's waiver of its lien and reclamation rights. This was clearly appropriate.

It is beyond dispute that section 364 authorizes a debtor to pay *some* price for post-petition credit. It is also clear that section 364 does not circumscribe the range of permissible credit terms that a debtor may propose or that the court may approve, apart from limiting the debtor's ability to offer superpriority status or collateral to ensure payment. For example, section 364 says nothing about price terms (including any applicable rate of interest or schedule of fees); the duration of the credit; or the creditor's collection rights upon the debtor's default. Instead, section 364 provides a plenary authorization to enable debtors to obtain credit on whatever terms the marketplace may require.

First, section 364(a) authorizes the debtor to obtain post-petition credit "in the ordinary course of business" – meaning credit that the debtor ordinarily would obtain to conduct its business operations, such as ordinary trade credit. The debtor pays for this category of credit as an unsecured expense of administration. Significantly, section 364(a) does not otherwise circumscribe the terms of credit, and no notice of the transaction or hearing is required for it to be valid. 11 U.S.C. § 364(a).

Second, section 364(b) authorizes the debtor to obtain post-petition credit other than under section 364(a). The debtor also pays for this category of credit as an expense of administration. Like section 364(a), section 364(b) does not circumscribe the parties' credit terms, but does require a hearing on notice for approval of the transaction. 11 U.S.C. § 364(b).

Third, section 364(c) authorizes the debtor to obtain and pay for post-petition credit on either a superpriority or secured basis. Unlike sections 364(a) and (b), this authorization has an exhaustion requirement: The debtor may only proceed under section 364(c) if it is unable to obtain credit under sections 364(a) or (b). Hence, section 364(c) expresses the policy that a debtor should use administrative expense priority treatment to pay for its post-petition credit wherever possible. The provision does not otherwise circumscribe the parties' credit terms, but notice and a hearing are required.

Finally, section 364(d) authorizes the debtor to obtain and pay for post-petition credit on a secured basis with the creditor's secured position priming other preexisting liens. This section has a stringent exhaustion requirement: The debtor must be unable to obtain credit under sections 364(a), (b), or (c). Further, the debtor must provide adequate protection to any lienholder prejudiced by the new lien granted to the post-petition lender. *See In re Qualitech Steel Corp.*, 276 F.3d 245, 247 (7th Cir. 2001) (observing that preexisting secured lenders entitled to replacement security to maintain their financial position where debtor placed new liens ahead of preexisting security interests). The section otherwise does not restrict the terms of credit, although notice and a hearing are required. 11 U.S.C. § 364(d).

In economic substance, the Vendor Order approves credit terms that are no different than if Kmart had agreed to buy goods from Irving post-petition at a price 10% higher than Irving normally would charge until Irving recouped its pre-petition loss for its unpaid pre-petition invoices. (Indeed, unpaid vendors often raise their prices on post-petition shipments to recoup pre-petition losses from bankrupt debtors if they have the leverage to do so, and sophisticated debtors, such as Kmart, are aware of this). Significantly, this type of transaction (the post-petition sale of goods at a marginally increased price) is authorized without a hearing or court order under section 364(a). In addition, under section 364(a), Kmart's obligation to pay for goods at a price that included a 10% increase would be accorded administrative expense status. Just as this type of transaction is authorized by section 364, so, too, is Irving's extension of credit under the terms of the Vendor Order.[8]

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8. The Bankruptcy Code does not define precisely the point at which the terms of a proposed credit transaction fall outside the "ordinary course of business" within the meaning of section 364(a). The distinction is irrelevant in this case, however, because credit terms that do not qualify under section 364(a) may nonetheless be approved under section 364(b). The only difference between the approval requirements of section 364(a) and (b) is that section (b) requires notice and a hearing. Because the bankruptcy court held a hearing on notice in this case, it is immaterial whether the Vendor Order is authorized under section (a) or section (b).

In this instance, of course, rather than sell goods to Kmart at a higher price post-petition, the Vendor Order authorized Kmart to obtain credit from Irving at a price that included the payment of Irving's pre-petition claim all at once. Moreover, Kmart's agreement to treat Irving's pre-petition claim as an administrative expense in exchange for Irving's agreement to extend post-petition credit involves an exchange of valuable consideration and was clearly not gratuitous.

As part of the bargain, Irving agreed to give up its lien and reclamation rights with respect to its pre-petition shipments (which rights, if proven, would have entitled Irving to have some, but not all, of its pre-petition claim treated as an administrative expense). Further, in binding itself to ship goods post-petition for a two-year period on ordinary credit terms (without interest, provision for collateral, additional fees, or other costly protections), Irving took on the risk that Kmart would not be able to pay all of its administrative claims in full. This is a considerable risk in chapter 11 proceedings, in which a substantial number of debtors are unable to pay in full all administrative claims.[9]

It is also clear that the bankruptcy court's entry of the Vendor Order was beneficial to Kmart's estate. Among other things, the estate obtained the benefit of Irving's extension of credit, the avoidance of litigation over Irving's lien and reclamation rights, the normalization of Kmart's relationship with a key supplier, and the avoidance of a potentially disastrous disruption in Kmart's business.

In its ruling, the Seventh Circuit stated that, before approving the payment of a vendor's pre-petition invoice as part of a credit transaction, the bankruptcy court must consider alternative means of enticing the vendor's business, such as payment for the shipments on a "COD" basis or by use of a letter of credit. (Pet. App. 12a). Section 364, however, explicitly eschews such a standard. The statute requires the exhaustion of alternative credit terms *only* in the context of selecting whether the creditor will receive payment of the price of the

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9. *See* note 5 *supra*.

credit on a superpriority or secured basis. No other exhaustion requirement exists, and none is warranted.

The Seventh Circuit also stated that vendors would have done business with Kmart even if their pre-petition claims had not been afforded administrative priority treatment, and the court used one of Kmart's food suppliers, Fleming, as an example. (Pet. App. 11a-12a). The court's analysis, however, is mistaken, both as a statutory presumption and as a factual predicate.

First, if businesses would never routinely refuse to sell goods and services to bankrupt debtors so long as they have assurance of future payment for future sales, then Congress would never have seen fit to enact section 366 of the Bankruptcy Code. 11 U.S.C. § 366 (providing that a utility may not discontinue service to a debtor because the debtor owes a pre-petition debt to the utility; and that a utility must provide post-petition service if given adequate assurance of post-petition payment for post-petition service). Contrary to the Seventh Circuit's analysis, section 366 reflects the reality that some suppliers may well refuse to do business with bankrupt debtors, even if provided assurance of future payment for future sales, and the list is not limited to utilities. *See In re Crawford*, 324 F.3d 539, 543 (7th Cir. 2003) (providing illustration of non-utility supplier who might refuse to sell goods to the debtor unless the debtor paid the supplier's pre-petition invoice). Conversely, if Congress had intended to prohibit post-petition suppliers of goods and services from discontinuing business with the debtor unless their pre-petition invoices were paid, Congress could have expanded section 366 to cover more than just utilities. Section 364, however, contains no such restriction.

Second, the Fleming example also disproves the Seventh Circuit's point. As the court observed, when Kmart eventually found an alternative supplier and ceased doing business with Fleming, Fleming failed immediately and filed its own bankruptcy case. (Pet. App. 12a). Had Kmart not paid Fleming's pre-petition claim at the outset of Kmart's bankruptcy case, Fleming would have failed before Kmart had the chance to find an alternative supplier. Because this would

have proved disastrous for Kmart at the outset of its case, it was appropriate for Kmart to pay Fleming's claim for the benefit of Kmart's estate.

With respect to other critical suppliers, the court below also overlooked the risks associated with Kmart's "playing chicken" with these vendors; the rights that these vendors gave up in agreeing to extend credit (e.g., their lien and reclamation rights); and the other benefits of the Vendor Order (discussed above). In this case, Kmart made a business judgment designed to preserve its estate for the benefit of all concerned. Kmart also explained its business judgment to the bankruptcy court and backed its explanation with an affidavit and live testimony. (Pet App. 48a-49a; 51a-58a; 67a-70a; 81a-84a). The bankruptcy court understood that the Vendor Order involved a financing transaction in which the suppliers would provide trade credit to Kmart – the relevant credit terms were clearly and comprehensively spelled out in the both Kmart's motion and the Order itself. (Pet. App. 30a-33a; 51a-56a). Kmart's presentation was adequate, and all agreed with Kmart's judgment to pursue the transactions, save one - Capital. Section 364 authorizes Kmart's decision, and the decision of the bankruptcy court to approve the Vendor Order should not have been overturned.

CONCLUSION

For the foregoing reasons, Irving respectfully requests that the Court issue a writ of certiorari to review the decision of the Seventh Circuit in this case.

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DECIDED FEBRUARY 24, 2004

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

Nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, 03-2348

In the Matter of: KMART CORPORATION,

Debtor-Appellant

Additional intervening appellants: Knight-Ridder, Inc.; Handleman Company; Irving Pulp & Paper, Limited

Argued Jan. 22, 2004.

Decided Feb. 24, 2004.

Rehearing and Rehearing En Banc Denied May 6, 2004.*

Before EASTERBROOK, MANION, and ROVNER, Circuit Judges.

EASTERBROOK, Circuit Judge.

On the first day of its bankruptcy, Kmart sought permission to pay immediately, and in full, the pre-petition claims of all "critical vendors." (Technically there are 38

* Chief Judge Flaum did not participate in the consideration of this petition.

debtors: Kmart Corporation plus 37 of its affiliates and subsidiaries. We call them all Kmart.) The theory behind the request is that some suppliers may be unwilling to do business with a customer that is behind in payment, and, if it cannot obtain the merchandise that its own customers have come to expect, a firm such as Kmart may be unable to carry on, injuring all of its creditors. Full payment to critical vendors thus could in principle make even the disfavored creditors better off: they may not be paid in full, but they will receive a greater portion of their claims than they would if the critical vendors cut off supplies and the business shut down. Putting the proposition in this way implies, however, that the debtor must *prove,* and not just allege, two things: that, but for immediate full payment, vendors *would* cease dealing; and that the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off.

Bankruptcy Judge Sonderby entered a critical-vendors order just as Kmart proposed it, without notifying any disfavored creditors, without receiving any pertinent evidence (the record contains only some sketchy representations by counsel plus unhelpful testimony by Kmart's CEO, who could not speak for the vendors), and without making any finding of fact that the disfavored creditors would gain or come out even. The bankruptcy court's order declared that the relief Kmart requested—open-ended permission to pay any debt to any vendor it deemed "critical" in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on "customary trade terms" for the next two years—was "in the best interests of the Debtors, their estates and their

creditors". The order did not explain why, nor did it contain any legal analysis, though it did cite 11 U.S.C. § 105(a). (The bankruptcy court issued two companion orders covering international vendors and liquor vendors. Analysis of all three orders is the same, so we do not mention these two further.)

Kmart used its authority to pay in full the pre-petition debts to 2,330 suppliers, which collectively received about $300 million. This came from the $2 billion in new credit (debtor-in-possession or DIP financing) that the bankruptcy judge authorized, granting the lenders super-priority in post-petition assets and revenues. See *In re Qualitech Steel Corp.*, 276 F.3d 245 (7th Cir.2001). Another 2,000 or so vendors were not deemed "critical" and were not paid. They and 43,000 additional unsecured creditors eventually received about 10¢ on the dollar, mostly in stock of the reorganized Kmart. Capital Factors, Inc., appealed the critical-vendors order immediately after its entry on January 25, 2002. A little more than 14 months later, after all of the critical vendors had been paid and as Kmart's plan of reorganization was on the verge of approval, District Judge Grady reversed the order authorizing payment. 291 B.R. 818 (N.D.Ill.2003). He concluded that neither § 105(a) nor a "doctrine of necessity" supports the orders.

Appellants insist that, by the time Judge Grady acted, it was too late. Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization. See *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003). If the orders in question are invalid, then the critical

vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors. Confirmation of a plan does not stop the administration of the estate, except to the extent that the plan itself so provides. Compare *In re Hovis,* 356 F.3d 820 (7th Cir. 2004), with *In re UNR Industries, Inc.,* 20 F.3d 766 (7th Cir. 1994). Several provisions of the Code do forbid revision of transactions completed under judicial auspices. For example, the DIP financing order, issued contemporaneously with the critical-vendors order, is sheltered by 11 U.S.C. § 364(e): "The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." Nothing comparable anywhere in the Code covers payments made to pre-existing, unsecured creditors, whether or not the debtor calls them "critical." Judges do not invent missing language.

Now it is true that we have recognized the existence of a longstanding doctrine, reflected in *UNR Industries,* that detrimental reliance comparable to the extension of new credit against a promise of security, or the purchase of assets in a foreclosure sale, may make it appropriate for judges to exercise such equitable discretion as they possess in order to protect those reliance interests. See also *In re Envirodyne Industries, Inc.,* 29 F.3d 301, 304 (7th Cir. 1994). Thus once action has been taken to distribute assets under a confirmed plan of reorganization, it would take some extraordinary

event to turn back the clock. These appeals, however, do not question any distribution under Kmart's plan; to the contrary, the plan (which was confirmed after the district court's decision) provides that adversary proceedings will be filed to recover the preferences that the critical vendors have received. No one filed an appeal, which means that it is appellants in this court that now wage a collateral attack on the plan of reorganization.

Appellants say that we should recognize their reliance interests: after the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts). Continued business relations may or may not be a form of reliance (that depends on whether the vendors otherwise would have stopped selling), but they are not *detrimental* reliance. The vendors have been paid in full for post-petition goods and services. If Kmart had become administratively insolvent, and unable to compensate the vendors for post-petition transactions, then it might make sense to permit vendors to retain payments under the critical-vendors order, at least to the extent of the post-petition deficiency. Because Kmart emerged as an operating business, however, no such question arises. The vendors have not established that any reliance interest—let alone any language in the Code—blocks future attempts to recover preferential transfers on account of pre-petition debts.

Handleman Company, which received $49 million as a critical vendor, makes a different procedural objection: that the district court's order does not affect it because Capital Factors' notice of appeal did not name Handleman as an appellee. Handleman was not a "party" in the district court

and, consistent with the due process clause of the fifth amendment, cannot be bound by the district judge's decision—or so it says. We permitted Handleman to intervene in this court. Thus it is a party today and will be bound by *our* decision, so it is hard to see why it matters whether the district judge's resolution would have had independent effect.

Notices of appeal in bankruptcy must name "all parties to the judgment, order, or decree appealed from." Fed. R. Bankr. P. 8001(a)(2). Handleman was not a "party" to the critical-vendors order; Kmart was the sole party at the time. Kmart filed an *ex parte* application that did not specify any particular creditor. It had notified only 65 creditors of its impending request, and none of these was among the 2,000 vendors to be left high and dry. The bankruptcy judge's order likewise did not identify any creditor that acquired rights, for *no* creditor acquired rights. All the order did was authorize Kmart to pay any vendor that Kmart in its discretion deemed "critical." The party that Capital Factors had to name thus was Kmart itself, and this it did. If the lack of personal notice about the proceedings before the district judge deprived Handleman of due process, then Kmart's application to the bankruptcy judge deprived about 47,000 unsecured creditors of due process! That would render the critical-vendors order void, and Handleman would be worse off—for then it would have to repay the money even if the order's entry otherwise would have been lawful. But there is no constitutional obligation to make every creditor a party to every contested matter in the bankruptcy. As a rule, a trustee or debtor in possession represents the interests of many stakeholders. Kmart vigorously represented the interests of Handleman and the other vendors Kmart deemed "critical."

Other creditors must look out for their own interests and intervene if need be—as Handleman could have done had it devoted to these proceedings the care that a $49 million stake warrants. Handleman will be a party, and receive all the notice that the Constitution requires, if Kmart initiates a preference-recovery action against it. As a party in this court, Handleman will not be allowed to contest matters resolved here; even the 2,327 critical vendors that are not parties in this court must accept the precedential effect of our decision. No rule of law requires personal notice to all entities that might be affected by the precedential (as opposed to the preclusive) force of an appellate decision. Today's opinion affects thousands of "critical vendors" and other unsecured creditors; decisions by the Supreme Court may affect millions of persons. Only those persons who will be formally bound by a decision are entitled to individual notice, and then only when practical (the lesson of many a class action, see *Mirfasihi v. Fleet Mortgage Corp.*, 356 F.3d 781, 785-86 (7th Cir. 2004).) So there was no flaw in the notice of appeal or the district judge's view that Kmart and Capital Factors were the only parties to the proceedings.

Thus we arrive at the merits. Section 105(a) allows a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code. This does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988); *In re Fesco Plastics Corp.*, 996 F.2d 152, 154 (7th Cir. 1993). *Cf. United States v. Noland*, 517 U.S. 535, 542, 116 S.Ct. 1524, 134

L.Ed.2d 748 (1996). Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full. See *In re Oxford Management Inc.*, 4 F.3d 1329 (5th Cir. 1993); *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *In re B & W Enterprises, Inc.*, 713 F.2d 534 (9th Cir. 1983). We agree with this view of § 105. "The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986).

A "doctrine of necessity" is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of "necessity"—*see Miltenberger v. Logansport Ry.*, 106 U.S. 286, 1 S.Ct. 140, 27 L.Ed. 117 (1882); *Fosdick v. Schall*, 99 U.S. 235, 25 L.Ed. 339 (1878)— today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. *Miltenberger* and *Fosdick* predate the first general effort at codification, the Bankruptcy Act of 1898. Today the Bankruptcy Code of 1978 supplies the rules. Congress did not in terms scuttle old common-law doctrines, because it did not need to; the Act curtailed, and then the Code replaced, the entire apparatus. Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding

entitlements to trump the text. See, e.g., *Lamie v. United States Trustee*, __ U.S. __, 124 S.Ct. 1023, 1029-31, 157 L.Ed.2d 1024 (2004), *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242-46, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989); *Bethea v. Robert J. Adams & Associates*, 352 F.3d 1125, 1128-29 (7th Cir. 2003). See also *Noland* (courts lack authority to subordinate creditors that judges, as opposed to legislators, believe should be lower in the hierarchy).

So does the Code contain any grant of authority for debtors to prefer some vendors over others? Many sections require equal treatment or specify the details of priority when assets are insufficient to satisfy all claims. E.g., 11 U.S.C. §§ 507, 1122(a), 1123(a)(4). Appellants rely on 11 U.S.C. §§ 363(b), 364(b), and 503 as sources of authority for unequal treatment. Section 364(b) reads: "The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense." This authorizes the debtor to obtain credit (as Kmart did) but has nothing to say about how the money will be disbursed or about priorities among creditors. To the extent that *In re Payless Cashways, Inc.*, 268 B.R. 543 (Bankr. W.D. Mo. 2001), and similar decisions, hold otherwise, they are unpersuasive. Section 503, which deals with administrative expenses, likewise is irrelevant. Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses. Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow. See *Boston & Maine Corp. v. Chicago*

Pacific Corp., 785 F.2d 562 (7th Cir. 1986). Treating pre-filing debts as "administrative" claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.

That leaves § 363(b)(1): "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a pre-petition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. Capital Factors insists that § 363(b)(1) should be limited to the commencement of capital projects, such as building a new plant, rather than payment of old debts—as paying vendors would be "in the ordinary course" but for the intervening bankruptcy petition. To read § 363(b)(1) broadly, Capital Factors observes, would be to allow a judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step. See *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506 (1996); *Noland, supra.* Yet what these decisions principally say is that priorities do not change unless a statute supports that step; and if § 363(b)(1) is such a statute, then there is no insuperable problem. If the language is too open-ended, that is a problem for the legislature. Nonetheless, it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code. We need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1).

Appendix A

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. See generally *Bank of America v. 203 N. LaSalle St. Partners,* 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). For the premise to hold true, however, it is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation—a demonstration never attempted in this proceeding—but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries. See 11 U.S.C. § 362. Fleming Companies, which received the largest critical-vendors payment because it sold Kmart between $70 million and $100 million of groceries and related goods weekly, was one of

these. No matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make. Nor was Fleming likely to walk away even if it had a legal right to do so. Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean. Again Fleming illustrates the point. When Kmart stopped buying its products after the contract expired, Fleming collapsed (Kmart had accounted for more than 50% of its business) and filed its own bankruptcy petition. Fleming was hardly likely to have quit selling of its own volition, only to expire the sooner.

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for pre-petition transactions. Kmart could have paid cash or its equivalent. (Kmart's CEO told the bankruptcy judge that COD arrangements were not part of Kmart's business plan, as if a litigant's druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a $2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest

way to do that would have been to put some of the $2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. For all the millions at stake, this proceeding looks much like the Chapter 13 reorganization that produced *In re Crawford,* 324 F.3d 539 (7th Cir. 2003). Crawford had wanted to classify his creditors in a way that would enable him to pay off those debts that would not be discharged, while stiffing the creditors whose debts were dischargeable. We replied that even though classification (and thus unequal treatment) is possible for Chapter 13 proceedings, see 11 U.S.C. § 1322(b), the step would be proper only when the record shows that the classification would produce some benefit for the disfavored creditors. Just so here. Even if § 362(b)(1) allows critical-

vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.

AFFIRMED.

APPENDIX B — MEMORANDUM OPINION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED APRIL 10, 2003

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

No. 02 C 1264.

April 10, 2003.

CAPITAL FACTORS, INC.,

Appellant,

v.

KMART CORPORATION,

Appellee.

MEMORANDUM OPINION

GRADY, District Judge.

Capital Factors, Inc. appeals from four final orders of the bankruptcy court that authorized Kmart to pay certain prepetition obligations. For the reasons explained below, the bankruptcy court's orders are reversed.

Appendix B

BACKGROUND

On January 22, 2002, Kmart Corporation and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession (collectively, "Kmart") filed a voluntary petition for reorganization pursuant to Chapter 11 of the United States Bankruptcy Code. As part of its "first day motions" filed on that date, Kmart sought authority to pay prepetition obligations to certain "critical vendors" (the "Critical Vendors Motion") and certain foreign vendors (the "Foreign Vendors Motion"). Kmart contended that these payments were necessary to maintain relationships essential to its continued operation and reorganization, and it invoked the "doctrine of necessity" and 11 U.S.C. § 105(a) for the bankruptcy court's authority to permit these payments.

The same day, the bankruptcy court held a hearing and heard evidence on these motions. Appellant Capital Factors, Inc. ("Capital") objected to both motions. (Capital is a factoring agent[1] for a number of Kmart's apparel suppliers, and it holds general unsecured claims against the bankruptcy estate of approximately $20 million.)

Regarding the Critical Vendors Motion, the court stated:

> Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our

1. A factoring agent purchases accounts receivable from its customers and assumes the collection responsibilities. *See Mr. Furniture Warehouse, Inc. v. Barclays Am./Commercial Inc.*, 919 F.2d 1517, 1519 (11th Cir. 1990).

> problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart's Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors—and I would like a list of the specific vendors that you would like included in this motion—as well as the advertising concerns, are necessary to keep this business going as a going concern.

(App. to Appellee's Brief, Ex. 4A, at 162.) Accordingly, the bankruptcy court granted the Critical Vendors Motion. Without reciting specific findings from the bench, the bankruptcy court also granted the Foreign Vendors Motion. (*Id.* at 173.) On January 25, the bankruptcy court entered written orders granting both motions.

On February 1 and 8, 2002, Kmart filed motions seeking authority to pay issuers of prepetition letters of credit (the "Letters of Credit Motion") and prepetition claims of certain liquor vendors (the "Liquor Vendors Motion"). On February 13, the bankruptcy court held a hearing on these motions, heard evidence, and granted both motions over Capital's objections. Regarding the Letters of Credit Motion, the court stated:

> Because the foreign vendors are integral to the reorganization of this Debtor and the Court already ruled on the payment of certain foreign vendors as part of the critical vendors motions

> and I believe that this is just a component of that particular transaction, and further finding that I may be inconsistent if I do not grant the relief that is requested here, I am going to go ahead and sign your order authorizing the reimbursement of the obligations to the issuers of Letters of Credit.

(*Id.*, Ex. 4B, at 251.) The bankruptcy court also granted the Liquor Vendors motion, "finding that there [was] a good business justification for it." (*Id.* at 269.) Written orders granting the motions were entered that same day.

Capital filed notices of appeal from each order, and we granted Capital's motion to consolidate the appeals. The parties' briefing is complete, and we heard oral argument on the appeals as well.

DISCUSSION

This court has jurisdiction over the instant appeals pursuant to 28 U.S.C. § 158(a)(1). On appeal from an order of the bankruptcy court, we review the bankruptcy court's factual findings under a "clearly erroneous" standard and its conclusions of law *de novo. See In re Smith,* 286 F.3d 461, 464-65 (7th Cir. 2002); Fed. R. Bankr. P. 8013.

Capital raises the following issues on appeal: (1) whether 11 U.S.C. § 105(a) or the "doctrine of necessity" provides a bankruptcy court with either statutory authority or equitable power to allow the payment of selected prepetition unsecured

trade claims prior to confirmation of a Chapter 11 plan;[2] (2) whether there was a sufficient evidentiary basis for the bankruptcy court to allow payment of certain prepetition claims; and (3) whether state laws prohibiting liquor wholesalers from selling products to Chapter 11 debtors legally unable to pay their prepetition debt are invalid or unenforceable to the extent that they conflict with the Bankruptcy Code.[3] Kmart raises the additional issue of whether Capital's appeals are moot because Kmart has already paid a substantial portion of the prepetition claims.

A. *The Bankruptcy Court's Power Under § 105*

We first examine the question of whether the bankruptcy court had the power to authorize the pre-plan payment of prepetition claims. The court relied on 11 U.S.C. § 105(a) to authorize the payments. Section 105(a) addresses the equitable powers of bankruptcy courts and provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the

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2. For convenience, we will refer to the time period prior to confirmation of a Chapter 11 plan as "pre-plan."

3. Capital also raises what it deems a separate issue of whether "a bankruptcy court may utilize" § 105(a) or the "doctrine of necessity" "to circumvent explicit provisions of the Bankruptcy Code." (Appellant's Brief at 2.) We view this issue as being part and parcel of the first issue listed *supra*.

> court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a). Although the bankruptcy court did not refer specifically to the equitable "doctrine of necessity" when ruling on the motions in open court or in its written orders,[4] Kmart relies on the doctrine. It is derived from the "necessity of payment rule," which was developed and used in railroad reorganizations "as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad." *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983). The rule has subsequently evolved into the "doctrine of necessity," which has been applied in non-railroad reorganizations to justify the pre-plan payment of prepetition claims of creditors who threaten to withhold goods or services believed critical to the debtor's continued viability and reorganization.[5] The doctrine is not codified anywhere in the Bankruptcy Code, so the only way to apply it is through § 105.

The Seventh Circuit has stated that the grant of equitable power in § 105 is limited in that it "allows [bankruptcy] courts

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4. As noted *supra*, the bankruptcy court did, however, find that the payments were "necessary," "integral," and that there was "good business justification" for them.

5. See 2 William L. Norton, Jr., *Norton Bankr. L. & Prac. 2d* § 42:11 (Supp. 2002), for a good discussion of the doctrine's history.

to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit." *In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993); *see also Gouveia v. Tazbir*, 37 F.3d 295, 300 (7th Cir. 1994) ("The Supreme Court has taught that any grant of authority given to the bankruptcy courts under § 105 must be exercised within the confines of the bankruptcy code.") (citing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988)).

The Bankruptcy Code sets forth a priority scheme for the payment of claims. *See* 11 U.S.C. §§ 503, 507. The Code does not carve out priority or administrative expense status for prepetition general unsecured claims based on the "critical" or "integral" status of a creditor. But the effect of the bankruptcy court's orders was to elevate the claims of the "critical" vendors over those of other unsecured creditors and to subordinate the claims of non-"critical" unsecured creditors. The bankruptcy court altered the priority scheme set forth in the Bankruptcy Code.

There is a split in the courts regarding whether § 105 authorizes bankruptcy courts to permit pre-plan payment of prepetition unsecured claims. As set forth in Kmart's briefs, many bankruptcy courts and a handful of district courts have held that bankruptcy courts do in fact have this power. *See, e.g., In re Just For Feet, Inc.*, 242 B.R. 821 (D. Del. 1999); *Michigan Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.)*, 80 B.R. 279 (S.D.N.Y. 1987); *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re Wehrenberg, Inc.*, 260 B.R. 468 (Bankr. E.D. Mo. 2001).

On the other hand, as Capital points out, a number of courts of appeals and a few lower courts have held just the opposite. *See, e.g., Official Comm. of Equity Sec. Holders v. Mabey,* 832 F.2d 299 (4th Cir. 1987); *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.),* 713 F.2d 534 (9th Cir. 1983); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.),* 4 F.3d 1329 (5th Cir. 1993); *In re FCX, Inc.,* 60 B.R. 405 (E.D.N.C. 1986); *In re Timberhouse Post & Beam, Ltd.,* 196 B.R. 547 (Bankr. D. Mont. 1996).[6] We agree with the latter courts' view that we cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of "equity," especially in light of the Seventh Circuit's admonition that "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.,* 791 F.2d 524, 528 (7th Cir. 1986).

We acknowledge that the application of the "doctrine of necessity" through § 105 in this situation is well-intended and may even have some beneficial results, in that pre-plan payment of certain prepetition claims allows the debtor to minimize disruptions in doing business, and thus may further

6. *Cf. Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.),* 963 F.2d 1490 (11th Cir. 1992) (bankruptcy court had no authority to allow cross-collaterization, a method of securing prepetition debt with prepetition and postpetition collateral); *Southern Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.),* 758 F.2d 137 (3d Cir. 1985) (bankruptcy court had no authority to grant lien status to a prepetition contractual indemnification claim); *Crowe & Assocs., Inc. v. Bricklayers & Masons Union Local No. 2 (In re Crowe & Assocs., Inc.),* 713 F.2d 211, 216 (6th Cir. 1983) (dictum).

reorganization. Nevertheless, it is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of prepetition unsecured claims.

Because we hold that the bankruptcy court did not have either the statutory or equitable power to authorize the pre-plan payment of prepetition unsecured claims, we need not address the second and third issues Capital raises on appeal.

B. ***"Equitable Mootness"***

Kmart does not persuade us that Capital's appeals are moot due to the fact that the prepetition claims have been substantially paid. Kmart makes much of the fact that Capital did not seek a stay of the bankruptcy court's orders. It is highly unlikely, however, that a motion to stay would have been successful. It would be inconsistent for the bankruptcy court to enter the orders on the theory that prompt payments were necessary to keep Kmart operational, and then turn around and stay those orders.[7] In any event, Capital was not required to seek a stay of the orders in order to preserve its appellate rights.

Kmart also argues that the appeals are "equitably moot" because effective relief on appeal has become imprudent and inequitable. The term "equitable mootness"

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7. *See* Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations,* 65 Am. Bankr. L.J. 75, 108 (1991).

was "anathematized by Judge Easterbrook"[8] in the case of *In re UNR Industries, Inc.*, 20 F.3d 766, 768 (7th Cir. 1994). The Seventh Circuit in *UNR* "banish[ed] the term 'equitable mootness' from the (local) lexicon," 20 F.3d at 769, because it is misleading: "[t]here is a big difference between *inability* to alter the outcome (real mootness) and *unwillingness* to alter the outcome ('equitable mootness')." *Id.* Nonetheless, the "now nameless doctrine" lives on and "is perhaps best described as merely an application of the age-old principle that in formulating equitable relief a court must consider the effects of the relief on innocent third parties." *Envirodyne*, 29 F.3d at 304. The basic questions under the doctrine, then, are these: is it prudent and fair to undo what the bankruptcy court did?[9] *See UNR*, 20 F.3d at 769; *Envirodyne*, 29 F.3d at 304.

Kmart argues that we should not reverse the orders allowing payment of the prepetition claims because the parties receiving the payments have already acted in reliance on them. As noted *supra* note 9, however, this is not a situation where there has been confirmation of a bankruptcy plan. Accordingly, it is not too late to order that the monies paid be returned. Kmart also claims that undoing the

8. *In re Envirodyne Indus., Inc.*, 29 F.3d 301, 304 (7th Cir. 1994).

9. As Capital points out, it is worth noting that most of the cases addressing or applying the doctrine involved appeals of orders confirming bankruptcy plans of reorganization. *See, e.g., UNR*, 20 F.3d 766; *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622 (4th Cir. 2002). Those cases are distinguishable from the instant proceeding because there has not yet been a confirmation of Kmart's plan.

bankruptcy court's orders would "paralyze" Kmart by forcing it to "undergo the Herculean task of immediately commencing thousands of lawsuits to collect hundreds of millions of dollars from thousands of vendors." (Appellee's Brief at 45-46.) We are not persuaded by Kmart's doomsday speculations. It is not evident that Kmart will have to sue to recover the payments, and in fact, Kmart cites no cases indicating that the bankruptcy court would not have the power to order the return of the monies paid.

C. *J.P. Morgan Chase's Brief*

J.P. Morgan Chase ("JPM"), which is an "administrative agent for the lenders under various pre-petition credit agreements among such lenders and Kmart" (JPM Brief at 1), has filed a supplemental brief regarding the Letters of Credit Motion. JPM contends that, even if the bankruptcy court did not have the authority under § 105 to authorize Kmart to pay the prepetition claims of the issuers of the letters of credit, the court "properly allowed those payments [pursuant to § 361 of the Bankruptcy Code] on the basis that such payments constituted adequate protection for the Issuers' secured reimbursement claims under the Letters of Credit." (JPM Brief at 2.) According to JPM, the issuers had statutory liens in the documents and the proceeds thereof presented by the foreign vendors to obtain payment under the letters of credit, and the issuers were entitled to adequate protection of those liens under § 361 of the Code.[10]

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10. Section 361 provides:

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(Cont'd)

Appendix B

In authorizing the payments to the issuers of the letters of credit, the bankruptcy court did not rely on § 361. We may affirm the bankruptcy court's decision on an alternative ground, but that ground must have been adequately presented in the bankruptcy court. *See Anderson v. U.S.F. Logistics (IMC), Inc.*, 274 F.3d 470, 478 (7th Cir.2001) (citing *Logan v. Caterpillar, Inc.*, 246 F.3d 912, 924 (7th Cir.2001)). Neither Kmart nor the issuers raised the adequate protection issue at the hearing on the Letters of Credit Motion. The bankruptcy court was not presented with evidence on whether the issuers held valid security interests nor whether they were entitled to adequate protection. There is an insufficient basis in the record to allow a finding that the payments to the issuers constituted adequate protection under § 361 of the Bankruptcy Code.

(Cont'd)

> 1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
>
> 2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
>
> 3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

Appendix B

CONCLUSION

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Liquor Vendors.

The case is remanded for further proceedings consistent with this opinion.

Docket Entry No. 37 (in No. 02–1264)

For the foregoing reasons, the following orders of the bankruptcy court are reversed: (1) Order Under 11 U.S.C. § 105 (a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors; (2) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing Payment of Prepetition Obligations Necessary to Obtain Imported Merchandise; (3) Order Pursuant to 11 U.S.C. §§ 105(a) and 363 Authorizing the Debtors to Honor Reimbursement Obligations to Issuers of Pre-Petition Letters of Credit Issued for the Benefit of the Debtors' Foreign Vendors; and (4) Order Under 11 U.S.C. § 105(a) Authorizing the Payment of

Appendix B

Prepetition Claims of Certain Liquor Vendors. The case is remanded for further proceedings consistent with this opinion.

Appellant's motion for an expedited ruling is denied as moot.

APPENDIX C — ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED JANUARY 25, 2002

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Chief Judge Susan Pierson Sonderby

In re:

KMART CORPORATION, et al.,

Debtors.

ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Upon the motion dated January 22, 2002 (the "Motion"), wherein Kmart Corporation ("Kmart") and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession in the above-captioned cases (collectively, the "debtors" or the "Company"), moved this Court for entry of an order, pursuant to section 105(a) authorizing the Debtors to pay Critical Vendor Claims; it appearing to the Court that (i) it has jurisdiction over the matters raised in the Motion

pursuant to 28 U.S.C. §§ 157 and 1334; (ii) this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); (iii) the relief requested in the Motion is in the best interests of the Debtors, their estates and their creditors; (iv) proper and adequate notice of the Motion and the hearing thereon has been given and that no other or further notice is necessary; and (v) upon the record herein, including the exhibits attached to the Notice of Filing of Exhibits as Ordered by the Court at the January 22, 2002 Hearing, filed on or about January 25, 2002, after due deliberation thereon, the relief should be granted as set forth below,

1. The Debtors are authorized, but not directed, in the reasonable exercise of their business judgment, to pay all, a portion or none of the prepetition claims (the "Critical Vendor Claims") of the following "Critical Vendors": (a) Fleming Companies, Inc.; (b) Handleman Company; (c) vendors who supply egg and dairy and (d) certain newspapers, printers, paper suppliers and other vendors who supply goods and services related to the Debtors' advertising program. The payment of the Critical Vendor Claims shall not exceed those set forth in the Motion upon such terms and in the manner provided in this Order and subject to the provisions of the Debtors' postpetition financing agreement.

2. Any checks used by the Debtors to pay Critical Vendor Claims shall contain a legend substantially in the following form:

> By accepting this check, the payee agrees to the terms of that certain Order of the United States Bankruptcy Court for the Northern District of

Illinois, dated as of _____, in the payor's chapter 11 case (Case No. _____), entitled "Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors," (including, if applicable, any Trade Agreement entered into pursuant to that Order) and submits to the jurisdiction of that Court for enforcement thereof.

3. The Debtors shall undertake appropriate efforts to cause Critical Vendors to enter into an agreement with the Debtors as provided herein as a condition of payment of their Critical Vendor Claims, which agreement shall include the following terms:

(a) The amount of such Critical Vendor's estimated Critical Vendor Claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Vendor and the Debtors (but such amount shall be used only for the purposes of determining such Critical Vendor's claim under this Order and shall not be deemed a claim allowed by the Court and the rights of all interested persons to object to such claim shall be fully preserved until further order of this Court);

(b) The Customary Trade Terms between such Critical Vendor and the Debtors, or such other terms as the Critical Vendors and the Debtors may agree;

(c) The Critical Vendor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such other favorable terms as the Debtors

and the Critical Vendor may otherwise agree, for a period at least two (2) years from the Petition Date, and the Debtors' agreement to pay in accordance with such terms;

(d) The Critical Vendor's agreement not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (a "Lien"), regardless of the statute or other legal authority upon which such Lien is asserted, related in any way to any remaining prepetition amounts allegedly owed to the Critical Vendor by the Debtors arising from agreements or other arrangements entered into prior to the Petition Date, and, to the extent the Critical Vendor has already obtained or otherwise asserted such a Lien, the Critical Vendor shall take whatever actions are necessary to remove such Lien;

(e) The Critical Vendor's acknowledgment that it has reviewed the terms and provisions of this Order and consents to be bound hereby; and

(f) The Critical Vendor's agreement that it will not separately seek payment for reclamation claims outside the terms of this Order unless the Critical Vendor's participation in the program to pay Critical Vendor Claims pursuant to this Order is terminated; *provided*, *however*, that such reclamation claims shall, if thereafter raised by the Critical Vendor as permitted by this Order, be treated as though raised on the date of this Order.

An agreement executed by and between the Debtors and a Critical Vendor as set forth in this paragraph shall be referred

to as a "Trade Agreement." This order is intended to authorize, but shall not require, the Debtors to enter in to Trade Agreements, it being the express intention of this Court that the Debtors shall enter into Trade Agreements only when the Debtors determine, in the exercise of their reasonable business judgment, that it is appropriate to do so.

4. The Debtors are authorized, in their discretion to make payments on account of Critical Vendor Claims in the absence of a Trade Agreement after the Debtors have undertaken diligent efforts to cause the Critical Vendor holding such Critical Vendor Claim to execute a Trade Agreement and if the Debtors determine, in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors' business operations.

5. If a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, or fails to comply with any Trade Agreement entered into between such Critical Vendor and the Debtors, then the Debtors may, in their discretion and without further order of the Court, (a) declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding post-petition claims of such vendors without further order of the Court or action by any person or entity, and, to the extent that payments on account of such Critical Vendor Claims exceed the postpetition claims of such vendors then outstanding without giving effect to any rights of setoff, claims, provision for

payment of reclamation or trust fund claims, or otherwise. In the event a Trade Agreement is terminated or a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, it is the explicit intention of this Court to return the parties to their position immediately prior to the entry of the order approving this Motion with respect to all prepetition claims.

6. The Debtors may, in their sole discretion, reinstate a Trade Agreement if:

(a) Such determination is subsequently reversed by the Court, after notice and a hearing following a motion by the Critical Vendor, for good cause shown that the determination was materially incorrect;

(b) The underlying default under the Trade Agreement was fully cured by the Critical Vendor not later than five (5) business days following the Debtors' notification to the Critical Vendor that a default had occurred; or

(c) The Debtors, in their discretion, reach a favorable alternative agreement with the Critical Vendor.

7. Nothing herein shall be construed to limit, or in any way affect, the Debtors' ability to dispute any Critical Vendor Claim.

8. Nothing contained in this order shall be deemed to constitute an assumption or rejection of any executory contract or agreement between the Debtors and a Critical

Vendor or to require the Debtors to make any of the payments authorized herein.

9. Notwithstanding the relief granted herein and any actions taken hereunder, nothing contained herein shall create, nor is it intended to create, any rights in favor of, or enhance the status of any claim held by, any person.

10. This Court shall retain jurisdiction to construe and enforce this Order.

Dated: Chicago, Illinois
January 25, 2002

/s/ Susan Pierson Sonderby
Chief Judge Susan Pierson Sonderby
UNITED STATES BANKRUPTCY JUDGE

APPENDIX D — NOTICE OF APPEAL FROM ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIISION DATED FEBRUARY 1, 2002

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

[Filed Feb. 1, 2002]

Chapter 11
No. 02 B 02474 (Jointly Administered)
Hon. Susan Pierson Sonderby.

IN RE: KMART CORPORATION, *et al.*,

Debtors.

NOTICE OF APPEAL FROM ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Pursuant to 28 U.S.C. § 158(a), Capital Factors, Inc. ("Capital") appeals from an order dated January 25, 2002, entitled "Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors," a copy of which is annexed hereto as Exhibit A and incorporated herein by this reference. A list of names of all parties known to Capital that have filed appearances or

requests for notice in these jointly administered chapter 11 cases is annexed hereto as Exhibit B and incorporated herein by this reference.

Respectfully submitted,

Capital Factors, Inc.
By: /s/ Steven B. Towbin
One of its attorneys

Dated: February 1, 2002

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Appendix D

In re Kmart Corporation, Case No.: 02-02474

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APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DENYING PETITION FOR REHEARING DATED MAY 6, 2004

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

May 6, 2004

Before

Hon. FRANK H. EASTERBROOK, Circuit Judge

Hon. DANIEL A. MANION, Circuit Judge

Hon. ILANA DIAMOND ROVNER, Circuit Judge

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

Nos. 02 C 1264
02 C 1265
02 C 2086
02 C 2088
John F. Grady, *Judge*

Appendix E

Nos. 03-2262, 03-2346, 03-2347 & 03-2348

In the matter of:

KMART CORPORATION,

Debtor-Appellant.

Appeal of:

IRVING PULP & PAPER, LIMITED,
doing business as IRVING PAPER

Order

Irving Pulp & Paper, Limited d/b/a Irving Paper filed a petition for rehearing and rehearing en banc on March 9, 2004. No judge in regular active service has requested a vote on the petition for rehearing en banc,* and all of the judges on the panel have voted to deny rehearing. The petition for rehearing is therefore DENIED.

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* Chief Judge Flaum did not participate in the consideration of this petition.

APPENDIX F — EXCERPTS FROM MOTION FOR ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Hon. Sonderby
Hearing Date: January 22, 2002
Hearing Time: 4:00 PM

In re:

KMART CORPORATION, *et al.*,

Debtors.

MOTION FOR ORDER UNDER 11 U.S.C. § 105(a) AUTHORIZING THE PAYMENT OF PREPETITION CLAIMS OF CERTAIN CRITICAL TRADE VENDORS

Kmart Corporation ("Kmart") and 37 of its subsidiaries and affiliates (the "Affiliate Debtors"), debtors and debtors-in-possession in the above-captioned cases (collectively, the "Debtors" or the "Company"), hereby move (the "Motion") this Court for an order, pursuant to section 105(a) of chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code"), authorizing the payment of prepetition claims of certain

critical trade vendors. In support of this Motion, the Debtors rely on the Affidavit of Charles C. Conaway, in Support of Chapter 11 Petitions and First Day Orders, sworn to on January 22, 2002. In further support of this Motion, the Debtors respectfully represent as follows:

BACKGROUND

A. *The Chapter 11 Filings*

* * *

1. On January 22, 2002 (the "Petition Date"), the Debtors filed a voluntary petition in this Court for reorganization relief under chapter 11 of the Bankruptcy Code. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1109 of the Bankruptcy Code. The Debtors have moved this Court for an order for joint administration of these chapter 11 cases. None of Kmart's international subsidiaries locate outside of the United States have filed for reorganization or insolvency protection in any jurisdiction and each continues to operate in the ordinary course of business.

2. No creditor's committee has yet been appointed in these cases. No trustee or examiner has been appointed.

3. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

4. The statutory predicates for the relief sought herein are section 105(a) of the Bankruptcy Code.

B. *Background and Current Business Operations*

5. Kmart is ranked number 36 on Fortune's list of 500 companies and is a member of the Fortune Global 100. It is the successor to the business developed by its founder, S.S. Kresge, who opened his first store in 1899. The first store using the Kmart name was opened in March 1962. Since that time, Kmart has become the nation's second largest discount retailer and the third largest general merchandise retailer. Approximately 75% of the U.S. population shops at Kmart each year and about 85% of the U.S. population presently lives within 15 miles of a Kmart store.

6. Kmart has approximately 240,525 associates worldwide and is one of the top twelve employers in the United States with approximately $5.2 billion in annual payroll and benefits. Kmart has relationships with more than 4,000 vendors worldwide and is one of the country's largest purchasers of products.

7. Kmart is focusing its merchandising and marketing approach on strengthening its brand positioning, pricing strategies, presentation and productivity to build customer loyalty and increase shopping frequency. Kmart aims to become the destination for what moms value by being her authority for her home and kids. It intends to do so by featuring popular national brands at competitive prices combined with new, distinct brands to differentiate itself in the marketplace. Kmart is continually growing its exclusive

private brand product offerings, which is highlighted by recent agreements with nationally recognized names, such as Joe Boxer, Disney and an extended contract for the exclusive sale of Martha Stewart home and garden products. Other high quality private brand collections available exclusively at Kmart include: Jaclyn Smith, Route 66 apparel, as well as Thom McAnn shoes, White Westinghouse appliances, Penske automotive products and BestYet.

* * *

RELIEF REQUESTED

14. By this Motion, the Debtors seek entry of an order authorizing, but not requiring, them to pay, in the reasonable exercise of their business judgment, the prepetition claims of certain critical vendors that are essential to the uninterrupted functioning of the Debtors' business operations, namely: (i) Fleming Companies, Inc. ("Fleming"), (ii) Handleman Company ("Handleman"), (iii) vendors who supply egg and dairy and (iv) certain newspapers, printers, paper suppliers and other vendors who supply goods and services related to the Debtors' advertising program (the "Critical Vendors", whose prepetition claims shall be identified as "Critical Vendor Claims"). Payment of the Critical Vendor Claims is vital to the Debtors' reorganization efforts, as (a) the goods and services provided by the Critical Vendors are often the only source from which the Debtors can procure certain goods or services, (b) failure to pay the Critical Vendor Claims would, in the business judgment of the Debtors, very likely result in the Critical Vendors terminating their provision of goods and/or services to the

Debtors, and/or (c) the Critical Vendors would themselves be irreparably damaged by the Debtors' failure to pay their prepetition claims, resulting in the Debtors being forced to try to obtain goods and services elsewhere that would either not be available, be at a higher price, at unfavorable terms to the Debtors, or not of the quality required by the Debtors. In addition, some of the specific Critical Vendors provide not only merchandise but also indispensable infrastructure and support to certain of the Debtors' store operations.

Fleming

15. Fleming is a food distribution company that provides substantially all of the food and consumable products in the Debtors' stores. Fleming is the Debtors' single largest supplier accounting for 11%, or $4.2 billion, of total sales by the Debtors on an annual basis. Fleming not only supplies the Debtors with merchandise but also provides the infrastructure for the Debtors' Food and Consumable operations, including buying and procuring merchandise, warehousing operations, transportation and logistics, and vendor allowance collection management. Cessation of these services would quickly result in a severe sales impact given the speed at which this type of inventory turns and the overall impact extreme out-of-stock levels would have on shoppers' willingness to shop at the Debtors' stores. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $76 million to Fleming.

Appendix F

Handleman

16. Handleman is the Debtors' sole music vendor, accounting for 1.5%, or $500 million, of total sales by the Debtors on an annual basis. Handleman not only supplies merchandise but also provides the infrastructure for the Debtors' music business. The product offering in the music department is unusually complex due to the number of different specific products offered and geographic sensitivity as it relates to music tastes. Handleman's employees fundamentally run the music department in each of the Debtors' stores in that they place merchandise orders for the stores, stock shelves, set up displays for new music releases, and operate the merchandise return process. Without Handleman, the Debtors would not be able to operate the infrastructure required to generate music sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $64 million to Handleman.

Egg and Dairy Vendors

17. The Debtors' supplier base for egg and dairy vendors is primarily composed of small vendors who are highly dependent on cash flow. Egg and dairy sales account for approximately 0.5%, or $160 million of total sales by the Debtors on an annual basis. Given the perishable nature of the product, the egg and dairy vendors directly stock the store on a daily basis. Without this support, the stores would be completely out of stock of this merchandise within two days. Further, approximately 8% of all shoppers purchase this merchandise category on a given shopping trip to the Debtors' stores. Without this product category, shoppers will be less likely to choose Kmart for their daily shopping needs, thus severely impacting the Debtors' overall sales. The Debtors

estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $6.8 million to egg and dairy vendors.

Advertising

18. The Debtors' weekly sales volume is highly dependent on their weekly newspaper circular program. Approximately 30%, or $11 billion of total sales are generated via advertised items. The Debtors print approximately 78 million circulars each week. These circulars are distributed nationally via newspapers to the Debtors' markets. Continuation of the entire circular advertising program, including circular layout and development, commodity paper procurement, circular printing, and newspaper placement and distribution, is critical to the ongoing health of the business. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $37 million to newspapers, ad production business, printers, and commodity paper suppliers.

A. Proposed Terms and Conditions of Payment of Critical Vendor Claims

19. The Debtors hereby request authorization to pay all, a portion or none of the Critical Vendor Claims as determined by the Debtors in their sole discretion in or to continue the vital goods and services provided by the Critical Vendors. The Debtors propose to condition the payment of Critical Vendor Claims on the agreement of individual Critical Vendors to continue supplying goods and services to the Debtors on the trade terms that such Critical Vendor provided

goods and/or services to the Debtors on a historical basis prior to the Petition Date (the "Customary Trade Terms"), or such other favorable trade practices and programs that are at least as favorable to the Debtors as those in effect during such time. The Debtors reserve the right to negotiate new trade terms with any Critical Vendor as a condition to payment of any Critical Vendor Claim.

20. To ensure that the Critical Vendors deal with the Debtors on Customary Trade Terms, the Debtors propose that (a) a letter substantially in the form of the letter attached hereto as *Exhibit A* be sent to the Critical Vendors along with a copy of the Order granting this Motion, and (b) the checks used to pay Critical Vendor Claims contain a legend substantially in the following form:

> By accepting this check, the payee agrees to the terms of that certain Order of the United States Bankruptcy Court for the Northern District of Illinois, dated as of _____, in the payor's chapter 11 case (Case No. _____), entitled "Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors," (including, if applicable, any Trade Agreement entered into pursuant to that Order) and submits to the jurisdiction of that Court for enforcement thereof.

21. The Debtors propose that the letter sent to Critical Vendors shall include, but not be limited to, the following terms:

Appendix F

(a) The amount of such Critical Vendor's estimated Critical Vendor Claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Vendor and the Debtors (but such amount shall be used only for the purposes of determining such Critical Vendor's claim under this Order and shall not be deemed a claim allowed by the Court and the rights of all interested persons to object to such claim shall be fully preserved until further order of this Court);

(b) The Customary Trade Terms between such Critical Vendor and the Debtors, or such other terms as the Critical Vendors and the Debtors may agree and the Critical Vendor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such other favorable terms as the Debtors and the Critical Vendor may otherwise agree;

(c) The Critical Vendor's agreement not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (a "Lien"), regardless of the statute or other legal authority upon which such Lien is asserted, related in any way to any remaining prepetition amounts allegedly owed to the Critical Vendor by the Debtors arising from agreements or other arrangements entered into prior to the Petition Date, and, to the extent the Critical Vendor has already obtained or otherwise asserted such a Lien, the Critical Vendor shall take whatever actions are necessary to remove such Lien;

(d) The Critical Vendor's acknowledgment that it has reviewed the terms and provisions of this Order and consents to be bound hereby; and

(e) The Critical Vendor's agreement that it will not separately seek payment for reclamation claims outside the terms of this Order unless the Critical Vendor's participation in the program to pay Critical Vendor Claims pursuant to this Order is terminated; *provided*, *however*, that such reclamation claims shall, if thereafter raised by the Critical Vendor as permitted by this Order, be treated as though raised on the date of this Order.

Such a letter, once agreed to and accepted by a Critical Vendor, shall be referred to herein as a "Trade Agreement."

22. By this Motion, the Debtors seek only the authority to enter into Trade Agreements, when the Debtors determine in their discretion that such an agreement is necessary, and not to be required to do so. The Debtors seek authority, to make payments on account of such Critical Vendor's claims, notwithstanding the fact that following diligent efforts to enter into a Trade Agreement with a Critical Vendor, no Trade Agreement has been reached, if the Debtors determine, in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors' business operations.

23. For those Critical Vendors who have agreed to ship goods or render services on trade terms other than their Customary Trade Terms, the Debtors reserve the right to obtain written acknowledgment of such terms on a

case-by-case basis. Nothing in this Motion should be construed as a waiver by any of the Debtors of their rights to contest any invoice of a Critical Vendor under applicable non-bankruptcy law.

24. If a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim, or fails to comply with any Trade Agreement entered into between such Critical Vendor and the Debtors, then the Debtors seek authority, in their discretion and without further order of the Court, (a) to declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) to declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding postpetition claims of such vendors without further order of the Court or action by any person or entity. In the event that such events occur, a Critical Vendor shall then immediately repay to the Debtors any payment made to it on account of its Critical Vendor Claims to the extent that payments on account of such Critical Vendor Claims exceed the postpetition claims of such vendors then outstanding without giving effect to any rights of setoff, claims, provision for payment of reclamation or trust fund claims, or otherwise. In sum, the Debtors seek to return the parties to their position immediately prior to the entry of the Order approving this Motion with respect to all prepetition claims in the event a Trade Agreement is terminated or a Critical Vendor refuses to supply goods and/or services to the Debtors on Customary Trade Terms following receipt of payment on its Critical Vendor Claim.

Appendix F

25. The Debtors further propose that any Trade Agreement terminated as a result of a Critical Vendor's refusal to comply with the terms thereof may be reinstated if:

(a) such determination is subsequently reversed by the Court, after notice and a hearing following a motion by the Critical Vendor, for good cause shown that the determination was materially incorrect;

(b) the underlying default under the Trade Agreement was fully cured by the Critical Vendor not later than five (5) business days following the Debtors' notification to the Critical Vendor that a default had occurred; or

(c) the Debtors, in their discretion, reach a favorable alternative agreement with the Critical Vendor.

26. Some of the Critical Vendors also may have obtained mechanics' liens, possessory liens, or other similar state law trade liens ("Trade Liens") on the Debtors' assets, based upon Critical Vendor Claims held by such vendors. As a further condition of receiving payment on a Critical Vendor Claim, a Critical Vendor must agree to take whatever action is necessary to remove the Trade Lien at such Critical Vendor's sole cost and expense.

B. Payment of the Critical Vendor Claims Is Necessary for the Debtors' Successful Reorganization in These Chapter 11 Cases

27. The Debtors believe that payment of the Critical Vendor Claims is necessary to effect their successful reorganization in these cases. If the Motion is not granted, the Critical Vendors are likely to discontinue providing goods to the Debtors on Customary Trade Terms, effectively reducing the amount of credit available to the Debtors. Moreover, the Debtors believe that certain of the Critical Vendors might cease to do business with the Debtors altogether, resulting in the Debtors' inability to obtain certain essential goods and services and forcing the Debtors to incur higher costs. As detailed further below, such actions would be harmful if not devastating to the Debtors, their estates and creditors.

28. The continued availability of trade credit in amounts and on terms consistent with those enjoyed by the Debtors prepetition is clearly of benefit to the Debtors in that it will permit them to maintain liquidity for their business operations. The Debtors believe that preserving working capital through the retention or reinstatement of traditional trade credit terms will enable them to maintain their competitiveness and maximize the value of their business, for the benefit of the Debtors, their estates and creditors. Conversely, a deterioration of trade credit and a disruption or cancellation in the delivery of goods or provision of services -- many of which are not readily replaceable -- would cripple the Debtors' business operations, increase the amount of funding needed by the Debtors postpetition, and ultimately hamper the Debtors' ability to service their customers, whose continued loyalty is vital to the successful reorganization of the Debtors' business.

29. In addition, the relief requested herein, if granted, will likely avert the filing of countless reclamation claims, suits, liens and motions by claimants seeking payment of or priority for their claims on a variety of grounds. Avoiding the time, distraction and considerable expense of litigating the merits of such claims will benefit the Debtors, their estates and creditors while facilitating the administration of these cases.

* * *

WHEREFORE the Debtors respectfully request that the Court enter an order (i) authorizing the Debtors to pay the Critical Vendor Claims, subject to the availability as may be permitted pursuant to the Debtors' postpetition financing agreement, and (ii) granting the Debtors such other and further relief as is just and proper.

Dated: Chicago, Illinois
January 12, 2002

Respectfully Submitted,

By: s/ J. Eric Ivester
John Wm. Butler, Jr. (ARDC No. 06209373)
J. Eric Ivester (ARDC No. 06215581)
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Attorneys for Debtors and
Debtors-in-Possession

Appendix F

EXHIBIT A

_____, 2002

To: [Essential Trade Creditor]
[Name]
[Address]

Dear Valued Supplier:

As you are no doubt aware, on _____, 2002 (the "*Petition Date*"), [Debtor], together with certain of its U.S. affiliates (collectively, the "*Debtors*"), filed voluntary petitions under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of Illinois (the "*Bankruptcy*" and the "*Bankruptcy Court*," respectively). On the Petition Date, we requested the Bankruptcy Court's authority to pay certain suppliers in recognition of the importance of our relationship with such suppliers and our desire that the Bankruptcy Cases have as little effect on them as possible. On _____, 2002, the Bankruptcy Court entered an order (the "*Order*") authorizing us, under certain conditions, to pay pre-bankruptcy claims of certain trade creditors that agree to the terms set forth below and to be bound by the terms of the Order. A copy of the Order is enclosed.

In order to receive payment on pre-bankruptcy claims, each selected trade creditor must agree to continue supplying goods to the Debtors based on "*Customary Trade Terms*." In the Order, Customary Trade Terms are defined as the normal and customary trade terms, practices and programs

(including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowance, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs) in effect between such trade creditor and the Debtors on a historical basis prior to the Petition Date or such other trade terms, practices and programs that are at least as favorable to the Debtors as those in effect during such time.

For purposes of administration of this trade program as authorized by the Bankruptcy Court, the Debtors and you agree as follows:

1. The estimated balance of the prepetition trade claim (net of any setoffs, credits or discounts (the "*Trade Claim*") that the Debtors will provisionally pay you is $

2. You will provide open credit terms as follows (if more space is required, attach continuation pages)

3. The open trade balance or credit line that you will extend to the Debtors for shipment of postpetition goods is $ _____3 (which shall not be less than the greater of the open trade balance outstanding: (a) on _____, 2002, or (b) on normal and customary terms on a historical basis for the period prior to the Petition Date).

4. In consideration for the payment described herein, you agree not to file or otherwise assert against any or all of the Debtors, their estates or any other person or entity or any of their respective assets or property (real or personal) any lien (regardless of the statute or other legal authority upon

which such lien is asserted) related in any way to any remaining prepetition amounts allegedly owed to you by the Debtors arising from agreements entered into prior to the Petition Date. Furthermore, if you have taken steps to file or assert such a lien prior to entering into this letter agreement, you agree to take all necessary steps to remove such lien as soon as possible.

5. You will hereafter extend to the Debtors all Customary Trade Terms (as defined in the Order).

Payment of your Trade Claim in the manner set forth in the Order may only occur upon execution of this letter by a duly authorized representative of your company and the return of this letter to the Debtors. Your execution of this letter agreement anti return of the same to the Debtors constitutes an agreement by you and the Debtors:

(a) to the Customary Trade Terms and, subject to the reservations contained in the Order, to the amount of the Trade Claim set forth above;

(b) that, for a period of no less that two (2) years from the Petition Date, you will continue to supply the Debtors with goods, pursuant to the Customary Trade Terms and that the Debtors will pay for such goods in accordance with Customary Trade Terms;

(c) that you have reviewed the terms and provisions of the Order and that you consent to be bound by such teams;

(d) that you will not separately seek payment for reclamation and similar claims outside of the terms of the Order unless your participation in the trade payment program authorized by the Order (the "*Trade Payment Program*") is terminated; and

(e) that if either the Trade Payment Program or your participation therein terminates as provided in the Order, any payments received by you on account of your Trade Claim will be deemed to have been in payment of then outstanding postpetition obligations owed to you and that you will immediately repay to the Debtors any payments made to you on account of your Trade claim to the extent that the aggregate amount of such payments exceed the postpetition obligations then outstanding without the right of any setoffs, claims, provision for payment of reclamation or trust fund claims, or otherwise.

The Debtors and you also hereby agree that any dispute with respect to this agreement, the Order and/or your participation in the Trade Payment Program shall be determined by the Bankruptcy Court.

If you have any questions about this Agreement or our financial restructuring, please do not hesitate to call (__) _____ or (__) _____.

Sincerely,

[Debtor]

By:

Its:

Appendix F

Agreed and Accepted by:
[Name of Trade Vendor]

By:

Its:

Dated:

APPENDIX G — EXCERPTS FROM AFFIDAVIT AND STATEMENT OF CHARLES C. CONAWAY IN SUPPORT OF CHAPTER 11 PETITIONS AND FIRST DAY ORDERS FILED JANUARY 25, 2002

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

Case No. 02-B02474
(Jointly Administered)
Chapter 11
Hon. Sonderby
Hearing Date: January 22, 2002
Hearing Time: 4:00 PM

In re:

KMART CORPORATION, *et al.*,

Debtors.

AFFIDAVIT AND STATEMENT OF CHARLES C. CONAWAY IN SUPPORT OF CHAPTER 11 PETITIONS AND FIRST DAY ORDERS

STATE OF ILLINOIS)
) ss:
COUNTY OF COOK)

I, Charles C. Conaway, being duly sworn, deposes and says:

Appendix G

1. I am the Chief Executive Officer of Kmart Corporation ("Kmart"), a corporation organized under the laws of the State of Michigan. The other debtors are: Kmart Corporation of Illinois, Inc.; Kmart of Indiana; Kmart of Pennsylvania LP; Kmart of Texas L.P.; Kmart of North Carolina LLC; Big Beaver of Florida Development, LLC; Bluelight.com LLC; Kmart Michigan Property Services, L.L.C.; TC Group I LLC; Troy CMBS Property, L.L.C.; Kmart Financing I; Big Beaver Development Corporation; Big Beaver of Caguas Development Corporation; Big Beaver of Guaynabo Development Corporation; BlueLight.com. Inc.; Kmart Holdings, Inc.; Kmart of Amsterdam, NY Distribution Center, Inc.; Kmart Stores of Indiana, Inc.; Kmart of Michigan, Inc.; Kmart Stores of TNCP, Inc.; Kmart Overseas Corporation; JAF, Inc.; VTA, Inc.; Big Beaver of Caguas Development Corporation II; Big Beaver of Carolina Development Corporation; Kmart Pharmacies, Inc.; Kmart Pharmacies of Minnesota, Inc.; Builders Square, Inc., Kmart CMBS Financing, Inc.; K mart International Services, Inc.; PMB, Inc.; Sourcing & Technical Services Inc.; ILJ, Inc.; STI Merchandising, Inc.; KBL Holding Inc.; KLC, Inc.; and S.F.P.R, Inc. (such debtors, the "Affiliate Debtors" and, together with Kmart, the "Debtors" or the "Company"). In addition to being the Chief Executive Officer of Kmart, I hold executive positions within or am an authorized representative of, each of the Affiliate Debtors. The Company's principal executive offices are located at 3100 West Big Beaver Road, Troy, MI 48084-3163.

2. I have been associated with the Company since 2000 and am familiar with the Company's day-to-day operations, business-affairs, and books and records. In recent weeks,

Appendix G

I have participated in the Company's discussions with potential debtor-in-possession ("DIP") lenders and am familiar with the existing credit facilities and the proposed DIP Credit Agreement. In my capacity as Chief Executive Officer, I am familiar with the Company's day-to-day operations, business affairs, and books and records.

3. I submit this affidavit in support of the first-day applications and motions in the above-captioned chapter 11 cases. Any capitalized term not expressly defined herein shall have the meaning ascribed to that term in the relevant first-day motion or application. Except as otherwise indicated, all facts set forth in this affidavit are based upon my personal knowledge, my review of relevant documents, or my opinion, based upon my experience and knowledge of the Company's operations and financial condition. If I were called upon to testify, I could and would testify competently to the facts set forth herein. I am authorized to submit this affidavit.

4. Part I of this affidavit describes the Company's business and the circumstances surrounding the filing of the Company's chapter 11 petitions. Part II sets forth the relevant facts in support of the Company's various first-day applications and papers filed concurrently herewith.

Appendix G

I. *BACKGROUND*

A. *The Chapter 11 Filings*

5. On January 22, 2002 (the "Petition Date"), the Debtors filed a voluntary petition in this Court for reorganization relief under chapter 11 of the Bankruptcy Code. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1109 of the Bankruptcy Code. The Debtors have moved this Court for an order for joint administration of these chapter 11 cases. None of Kmart's international subsidiaries located outside of the United States have filed for reorganization or insolvency protection in any jurisdiction and each continues to operate in the ordinary course of business. In order to enable the Company to operate effectively and to avoid the adverse effects of the chapter 11 filings, the Company will request various types of relief in "first-day" applications and motions filed with the Court.

* * *

Critical Prepetition Trade Vendors

183. Payment of the Critical Vendor Claims is vital to the Debtors' reorganization efforts, as (a) the goods and services provided by the Critical Vendors are often the only source from which the Debtors can procure certain goods or services, (b) failure to pay the Critical Vendor Claims would, in the business judgment of the Debtors, very likely result in the Critical Vendors terminating their provision of goods and/or services to the Debtors, and/or (c) the Critical Vendors

would themselves be irreparably damaged by the Debtors' failure to pay their prepetition claims, resulting in the Debtors being forced to try to obtain goods and services elsewhere that would either not be available, be at a higher price, at unfavorable terms to the Debtors, or not of the quality required by the Debtors. In addition, some of the specific Critical Vendors provide not only merchandise but also indispensable infrastructure and support to certain of the Debtors' store operations.

Fleming

184. Fleming is a food distribution company that provides substantially all of the food and consumable products in the Debtors' stores. Fleming is the Debtors' single largest supplier accounting for 11%, or $4.2 billion, of total sales by the Debtors on an annual basis. Fleming not only supplies the Debtors with merchandise but also provides the infrastructure for the Debtors' Food and Consumable operations, including buying and procuring merchandise, warehousing operations, transportation and logistics, and vendor allowance collection management. I believe that cessation of these services would quickly result in a severe sales impact given the speed at which this type of inventory turns and the overall impact extreme out-of-stock levels would have on shoppers' willingness to shop at the Debtors' stores. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $76 million to Fleming.

Appendix G

Handleman

185. Handleman is the Debtors' sole music vendor, accounting for 1.5%, or $500 million, of total sales by the Debtors on an annual basis. Handleman not only supplies merchandise but also provides the infrastructure for the Debtors' music business. The product offering in the music department is unusually complex due to the number of different specific products offered and geographic sensitivity as it relates to music tastes. Handleman's employees fundamentally run the music department in each of the Debtors' stores in that they place merchandise orders for the stores, stock shelves, set up displays for new music releases, and operate the merchandise return process. I believe that without Handleman, the Debtors would not be able to operate the infrastructure required to generate music sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $64 million to Handleman.

Egg and Dairy Vendors

186. The Debtors' supplier base for egg and dairy vendors is primarily composed of small vendors who are highly dependent on cash flow. Egg and dairy sales account for approximately 0.5%, or $160 million of total sales by the Debtors on an annual basis. Given the perishable nature of the product, the egg and dairy vendors directly stock the store on a daily basis. Without this support, the stores would be completely out of stock of this merchandise within two days. Further, approximately 8% of all shoppers purchase this merchandise category on a given shopping trip to the Debtors'

stores. I believe that without this product category, shoppers will be less likely to choose Kmart for their daily shopping needs, thus severely impacting the Debtors' overall sales. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $6.8 million to egg and dairy vendors.

Advertising

187. The Debtors' weekly sales volume is highly dependent on their weekly newspaper circular program. Approximately 30%, or $11 billion of total sales are generated via advertised items. The Debtors print approximately 78 million circulars each week. These circulars arc distributed nationally via newspaper to the Debtors' markets. I believe that continuation of the entire circular advertising program, including circular layout and development, commodity paper procurement, circular printing, and newspaper placement and distribution, is critical to the ongoing health of the business. The Debtors estimate that, as of the Petition Date, they owe Critical Vendor Claims of approximately $37 million to newspapers, ad production business, printers, and commodity paper suppliers.

* * *

Reclamation Claims

195. Prior to the date hereof, the Debtors received demands from several parties asserting a right of reclamation pursuant to Section 2-702(2) of the Uniform Commercial Code (the "UCC"). Moreover, as a result of the commencement of

these cases, the Debtors expect to receive numerous reclamation claims pursuant to section 546(c) of the Bankruptcy Code (collectively, the "Reclamation Claims"). The Reclamation Claims request That the Debtors either return certain goods (collectively, the "Goods") purportedly delivered to the Debtors on or prior to the commencement of these cases.

196. It is of paramount importance for the Debtors to maintain normal business operations and avoid costly and distracting litigation relating to Reclamation Claims. I believe that if the Debtors are unable to establish a global set of reclamation procedures to resolve the Reclamation Claims, they will be faced with the prospect of simultaneously defending multiple reclamation adversary proceedings at a time when the Debtors need to focus on critical aspects of the reorganization process.

197. Although the Debtors have not completed their review of these demands, they believe that many of the Reclamation Claims may be valid, in whole or in part, subject to certain defenses the Debtors may have to such demands. In addition, while the Debtors do not concede that any of the elements necessary to prove a right of reclamation have been shown by any of their vendors, the Debtors should seek to adopt a uniform procedure for determining and settling all valid Reclamation Claims so that litigation regarding Reclamation Claims does not interfere with the Debtors' reorganization efforts.

Appendix G

198. I believe that many Sellers will attempt, pursuant to section 546(c) of the Bankruptcy Code, to assert their right to reclaim Goods delivered to the Debtors shortly before or soon after the Petition Date. Indeed, certain Sellers have already sent prepetition notices of reclamation and these Sellers may attempt to reclaim their Goods and otherwise interfere with the sale of Goods delivered to the Debtors within any applicable reclamation period. As a result, the Debtors' business operations may suffer and management's attention will be diverted from important operational issues in order to deal with the reclamation claimants.

* * *

FURTHER AFFIANT SAYETH NOT.

s/ Charles C. Conaway
Charles C. Conaway

Sworn to before me this 22nd
day of January, 2002

s/ Angeline M. Negron
Notary Public

APPENDIX H — COMPLAINT TO AVOID TRANSFER OF PROPERTY AND FOR RECOVERY DATED JANUARY 22, 2004 AND FILED JANUARY 26, 2004

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Chapter 11

Case No. 02 B 02474
(Jointly Administered)
Honorable Susan Pierson Sonderby

In re:

KMART CORPORATION, et al.,

Debtor.

KMART CORPORATION,

Plaintiff

v.

IRVING PAPER, INC. aka IRVING PULP PAPER SALES, J.D. IRVING, LIMITED,

Defendant.

COMPLAINT TO AVOID TRANSFER OF PROPERTY AND FOR RECOVERY

Appendix H

Plaintiff Kmart Corporation ("Kmart"), the reorganized debtor herein, brings this adversary Complaint against IRVING PAPER, INC. ("Defendant"), stating as follows:

VENUE AND JURISDICTION

1. Plaintiff is a Michigan corporation with its principal place of business in Troy, Michigan. Kmart confirmed its First Amended Joint Plan of Reorganization, as modified (the "Plan") on April 23, 2003. The Plan became effective on May 6, 2003. Kmart possesses standing to bring this action pursuant to the terms of the Plan.

2. This adversary proceeding is brought pursuant to, and under, Rule 7001 of the Federal Rules of Bankruptcy Procedure. This Court has subject matter jurisdiction over this action pursuant to 11 U.S.C. §549 and §1142 and 28 U.S.C. § 1334 because it arises under the United States Bankruptcy Code ("Bankruptcy Code") and is related to the above-captioned case. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

3. Venue is proper in this District pursuant to 28 U.S.C. § 1409(a).

GENERAL ALLEGATIONS

4. On January 22, 2002, Kmart and certain of its domestic subsidiaries and affiliates, debtors and debtors-in-possession filed a voluntary petition for reorganization pursuant to Chapter 11 of the Bankruptcy Code. On January 25, 2002, this Court authorized the

payment of prepetition claims to certain critical trade vendors, including the Defendant ("January 25, 2002 Order"). Pursuant to that authorization, Kmart paid the Defendant $3,254,072.63 (the "Payment") near the outset of these bankruptcy proceedings.

5. Capital Factors, Inc., a factoring agent for a number of Kmart's apparel suppliers holding millions of dollars in unsecured claims against the bankruptcy estate, appealed the January 25, 2002 Order to the District Court. On April 10, 2003, the District Court reversed this Court, finding that payments for prepetition claims such as those enabled by the January 25, 2002 Order, "simply are not authorized by the Bankruptcy Code." *Capital Factors, Inc. v. Kmart Corporation*, 291 B.R. 818, 823 (N.D. Ill. 2003). The ruling of the District Court is on appeal to the Seventh Circuit Court of Appeals.

6. Kmart informed the District Court that, by the time of the appeal, it had already made disbursements to critical vendors such as the Defendant. The District Court nonetheless held that "it is not too late to order that the monies be returned." *Capital Factors*, 291 B.R. at 824. In furtherance of that ruling, Kmart now seeks avoidance and recovery of its prepetition payment to the Defendant.

Appendix H

COUNT I

(For Avoidance and Recovery Pursuant to 11 U.S.C. §§ 549, 550)

7. Kmart hereby realleges and incorporates by reference paragraphs 1 through 6 above as though fully set forth at length.

8. Kmart transferred money to the Defendant after the January 22, 2002 commencement of these bankruptcy proceedings.

9. Pursuant to the decision of the District Court more fully described above, the Payment constitutes an unauthorized postpetition transfer of property of Kmart's estate. Accordingly, the transfer is avoidable pursuant to 11 U.S.C. § 549, and Kmart may recover the value of the transfer pursuant to 11 U.S.C. § 550.

WHEREFORE, Kmart requests that the Court enter judgment: (1) avoiding the above described transfer pursuant to 11 U.S.C. § 549; (2) granting Kmart a judgment against the Defendant pursuant to 11 U.S.C. § 550 for the full amount of the Payment, with lawful pre- and post-judgment interest and costs; and (3) granting such other and further relief, at law or in equity, as appropriate under the circumstances.

Appendix H

COUNT II

(For Avoidance and Recovery Pursuant to 11 U.S.C. § 105)

10. Kmart hereby realleges and incorporates by reference paragraphs 1 through 9 above as though fully set forth at length.

11. 11 U.S.C. § 105 provides this Court with the power to enter any order that is "necessary or appropriate to carry out the provisions of this title." Since the January 25 Order has been reversed, it would be contrary to the Bankruptcy Code and inequitable for Defendant to be permitted to retain the Payment and thereby be paid in full on its pre-petition claim when all other unsecured creditors were not paid in full.

WHEREFORE, Kmart requests that the Court enter judgment: (1) avoiding the above-described transfer pursuant to 11 U.S.C. § 105; (2) granting Kmart a judgment against the Defendant for the full amount of the Payment, with lawful pre- and post-judgment interest and costs; and (3) granting such other and further relief, at law or in equity, as is appropriate under the circumstances.

DATED: January 22, 2004.

Appendix H

KMART CORPORATION
By William J. Barrett
One of its attorneys

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APPENDIX I — EXCERPTS FROM TRANSCRIPT OF PROCEEDINGS DATED JANUARY 22, 2002

IN THE UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 02-B 02474

JANUARY 22, 2002
4:00 P.M.
Chicago, Illinois

KMART CORPORATION,

Debtors.

TRANSCRIPT OF PROCEEDINGS BEFORE THE HONORABLE SUSAN PIERSON SONDERBY
APPEARANCES:

For the Debtor:	Mr. Jack Butler; Mr. Eric Ivester;
For the U.S. Trustee:	Ms. Kathryn Gleason;
For Footstar, Inc.:	Mr. David Cleary;
For Cardinal:	Mr. Ronald R. Peterson;
For Penske and Sara Lee:	Mr. David Missner;
For Ramco Gershenson, New Plan Excel Realty Trust, the Rouse Company Affiliates:	Ms. Synde Keywell;

Appendix I

For G E Capital:	Mr. Sheldon Solow; Mr. Gary Holtzer;
For Disney:	Ms. Deborah Thorne;
For Comerica:	Mr. Kurt Carlson
For Fleming	Mr. John Delnero

[2] APPEARANCES

For Capital Factors	Mr. Steven Towbin;
For VS Food Service:	Mr. Clinton Hansen;
For the SEC:	Ms. Angela Dodd;
For JP Morgan Chase:	Mr. Jeffrey Marwil; Mr. Brian Graham; Mr. Robert Scheibe; Mr. Jay Teitelbaum;
For Various Unsecured Creditors:	Mr. Randall Klein;
For Knight Ridder:	Mr. Joseph Frank;
Court Rep order:	Amy B. Doolin, CSR, RPR U.S. Courthouse 219 South Dearborn Chicago, Illinois 60604

[3] KMART CORPORATION
02 B 2474
January 22, 2002

INDEX

Witness:	DX	CX	RDX	RCX
Charles Conaway	139	154		

Appendix I

[4] THE CLERK: Now taking up Kmart Corporation, 02 B 2474.

* * *

CHARLES CONAWAY, WITNESS, SWORN

DIRECT EXAMINATION

BY MR. BUTLER:

Q Mr. Conaway, what is your position?

A I'm chief executive officer of Kmart.

Q How long have you been in that position?

A Since May of 2000.

Q Have you been in the courtroom during the presentation of the debtors' critical prepetition trade vendor motion?

A Yes, sir.

[140] Q Did you play any role in making a business judgment with respect to whether this motion would be brought before this court?

A Absolutely. I led the role.

Q Would you describe what your role was, please.

Appendix I

A We have over 4,000 vendors, and we looked with an incredible amount of analysis, and not just from a tactical standpoint but from a strategic standpoint, on what vendors could potentially have serious harm to the business if we were not able to continue. And we came down to a very small list, which is the one that was presented to the court.

* * *

BY MR. BUTLER:

Q You also testified in your affidavit, Mr. Conaway, to advertising issues. Can you explain to the court why advertising is considered a critical vendor when you've excluded so many other vendors from this program?

A Yeah. We are a high-low retailer. High-low retailer meaning that our main way of going to market is with an advertising program. We have a ROTO (phonetic) or circular that is out in the market every Sunday, 52 weeks a year, and then we also have additional advertising throughout the year in addition to that, that may break midweek or around a holiday, depending around critical sales periods.

Our business, as I mentioned, about 20 percent of our business is really driven by this ROTO. It is a critical element. Not just those sales, but what it does to the overall business. So we use the ad not just to drive promotional merchandise, but also to [150] drive the footsteps into the stores so we can sell other things that are not in it.

Appendix I

Our ROTO program is all based primarily with major newspapers, and local newspapers in smaller markets. We have no alternative in most of the major markets. If we were not to get placement in an ad program, it would be devastating to the program, to our overall business model.

THE COURT: Could you explain what this entire circular advertising program, including circular layout and development, commodity paper, procurement, circular printing, newspaper placement and distribution, is.

THE WITNESS: Yeah. That whole program is the production of our circulars, which for the most part, your Honor, gets inserted into the newspaper every Saturday or Sunday, depending on the market. Our ad layout, essentially we are working about 12 weeks out, meaning items that are going to be dropping in 12 weeks from now, the actual circular is already done. So there is not a long lead time to do that.

The program is worked out every week, coordinated with our supplier base to make sure that we have the appropriate in-stock position. If we don't, rain check is a critical component to not disappoint our [151] customer. And that whole production of that ad is done through the various components that you asked.

THE COURT: So you have planned now for circulars to be inserted in newspapers going out 12 weeks?

THE WITNESS: Yes. This week would be for 12 weeks out, would be final. So as of next week we couldn't change anything in that circular, the actual physical circular.

* * *

Q All right. The last question I want to ask you, Mr. Conaway is you heard, I think during this hearing, the court's concern about how you differentiate between these vendors that you have deemed as critical and your other 3,995 vendors. And can you explain to the court in your own words how you reached the business judgment that these vendors ought to be brought forward on this program as opposed to the other nearly 4,000 vendors.

A Yes. There is really two dimensions. One was strategically of what does it mean for the business, meaning what is its role; within the category I talked about, Fleming, and how important that is from a commodity and frequency building standpoint. And the second one, quite frankly, which was the overriding one, was do we have any alternatives. In virtually all of [154] these cases from a practical matter when we walked through them, we don't have any viable alternatives. And given that we would have to exit that business, it would severely deteriorate the business in any one of those segments.

* * *

MR. TOWBIN:

* * *

[135] The problem I have is that if you grant this motion then the next things that happens is if Mr. Peterson is wrong in the prior motion and he's unsecured, they're going to say, well, he's vital, you know, so we've got to have him. So we're now going to pay the $37 million to him. Then the

next thing, you know, is the next guy who's got a consignment, GE Credit or whoever, and maybe their goods are, you know necessary. Everybody's goods are necessary.

The problem I have with this is that it's only a little bit of money, it's you know, done all over and its a Delaware kind of thing, you know, is that the Bankruptcy Code doesn't allow for this. And I think we have to make a decision either we're going to follow the Bankruptcy Code or we're not. This doctrine of necessity, Your Honor that I think — and there's lots of, you know, law on that. It started with the railroads, you know, and equity receiverships in the 1890s, the public good and it's really never been applied, you know, in this jurisdiction.

* * * *

APPENDIX J — EXCERPTS FROM TAPE TRANSCRIPTION DATED JANUARY 22, 2004

TAPE TRANSCRIPTION

RE: KMART CORP. v. CAPITAL FACTORS, INC.

U.S. COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

ORAL ARGUMENT - JANUARY 22, 2004

Transcribed by: Theresa Bergstrand, LSR
Brandon Smith Reporting Service, LLC
44 Capitol Avenue
Hartford, CT 06106
(860) 549-1850

* * *

SEVENTH CIRCUIT: So it's your view that none of this is done at arm's length, I take it? When you talk about cutting deals, that doesn't sound like you think it's arm's length.

MR. TOWBIN: No, I didn't mean to imply that, Your Honor. I think there was negotiation, there might have been negotiation pre-petition with some of the major vendors, but there was probably a negotiation post-petition as far as that. I don't mean to imply that there was any underhanded methods here at all.

* * * *

Supreme Court, U.S.
FILED
OCT 13 2004
OFFICE OF THE CLERK

Nos. 03-1581, 03-1583, 04-181

In The
Supreme Court of the United States

KNIGHT-RIDDER, INC.,
Petitioner,
v.
CAPITAL FACTORS, INC., *et al.*,
Respondents.

HANDLEMAN COMPANY,
Petitioner,
v.
CAPITAL FACTORS, INC., *et al.*,
Respondents.

IRVING PULP & PAPER, LIMITED, dba IRVING PAPER,
Petitioner,
v.
CAPITAL FACTORS, INC., *et al.*,
Respondents.

On Petitions For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF IN OPPOSITION OF CAPITAL FACTORS, INC.

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CORPORATE DISCLOSURE STATEMENT PURSUANT TO SUPREME COURT RULE 29.6

Respondent Capital Factors, Inc. ("Capital") hereby represents that (i) Capital Factors Holding, Inc. ("Capital Holding") is Capital's parent company; (ii) Regions Financial Corporation, a publicly held corporation, is Capital Holding's parent company; and (iii) no other publicly held company owns 10 percent or more of Capital's stock.

TABLE OF CONTENTS

Page

CORPORATE DISCLOSURE STATEMENT PURSUANT TO SUPREME COURT RULE 29.6 i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

BRIEF IN OPPOSITION 1

INTRODUCTION 1

REASONS FOR DENYING THE PETITIONS 3

I. Notwithstanding Knight-Ridder's Contention To The Contrary, The Seventh Circuit's Analysis Of § 363(b) Was Consistent With *Lionel* And Its Progeny 3

II. Handleman Ignores The Seventh Circuit's Holding And Focuses Upon Its Dicta 7

A. The Handleman Petition reflects a fundamental misunderstanding of the *in rem* nature of the critical-vendors order and the district court's reversal of that order 7

B. The Seventh Circuit correctly short-circuited Handleman's due process argument because (i) the critical-vendors order granted no rights to Handleman, and (ii) Handleman had no consequent property interest at stake in the district court appeal 11

III. Irving's Petition Seeks An Advisory Opinion On The Scope Of § 364(e) 14

CONCLUSION 21

TABLE OF AUTHORITIES

Page

CASES

Andrews Univ. v. Merchant (In re Merchant), 958 F.2d 738 (6th Cir. 1992) 19

Armstrong v. Manzo, 380 U.S. 545 (1965) 13

Ashcroft v. Mattis, 431 U.S. 171 (1977) 20

Black v. Cutter Labs., 351 U.S. 292 (1956) 11

Board of Regents v. Roth, 408 U.S. 564 (1972) 12

City of New York v. New York, N.H. & H.R. Co., 344 U.S. 293 (1953) 13

Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983) 3, 4, 5, 6, 7

Diamond v. Charles, 476 U.S. 54 (1986) 20

GAC Enters., Inc. v. Medaglia (In re Medaglia), 52 F.3d 451 (2d Cir. 1995) 13

Griggs v. Provident Consumer Disc. Co., 459 U.S. 56 (1982) 9

Grossie v. Sam (In re Sam), 894 F.2d 778 (5th Cir. 1990) 14

Helicopteros Nationales De Colombia, S.A. v. Hall, 466 U.S. 408 (1984) 10

In re Abbotts Dairies of Pa., Inc., 788 F.2d 143 (3d Cir. 1986) 18

In re Adams Apple, Inc., 829 F.2d 1484 (9th Cir. 1987) 16

In re EDC Holding Co., 676 F.2d 945 (7th Cir. 1982)... 17, 19

In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004) .....*passim*

In re Revco D.S., Inc., 901 F.2d 1359 (6th Cir. 1990) 18

TABLE OF AUTHORITIES – Continued

Page

In re Sportfame, 40 B.R. 47 (Bankr. N.D. Ohio 1984) 19

Institutional Creditors of Cont'l Airlines, Inc. v. Cont'l Airlines, Inc. (In re Cont'l Airlines, Inc.), 780 F.2d 1223 (5th Cir. 1986) 5

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) 17

Lansdale Family Rests., Inc. v. Weis Food Serv. (In re Lansdale Family Rests., Inc.), 977 F.2d 826 (3d Cir. 1992) 19

Local Loan v. Hunt, 292 U.S. 234 (1934) 8

Martin v. Wilks, 490 U.S. 755 (1989) 10

Mennonite Bd. of Missions v. Adams, 462 U.S. 791 (1983) 13

Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306 (1950) 13

Nelson v. Adams USA, Inc., 529 U.S. 460 (2000) 14

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984) 7

Ortiz v. Fibreboard Corp., 527 U.S. 815 (1999) 10, 14

Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.), 16 F.3d 552 (3d Cir. 1994) 16

Richards v. Jefferson County, 517 U.S. 793 (1996) 10

Ruth v. Delano, 338 U.S. 226 (1949) 20

Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992) 16, 17, 18

Stephens Indus., Inc. v. McClung, 789 F.2d 386 (6th Cir. 1986) 5

TABLE OF AUTHORITIES – Continued

Page

Stickel v. United States, 76 S. Ct. 1067 (1956) 11

Tenn. Student Assistance Corp. v. Hood, 124 S. Ct. 1905 (2004) 8, 9

Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.), 945 F.2d 1089 (9th Cir. 1991) 16, 17, 18, 20

Tulsa Prof'l Collection Servs. v. Pope, 485 U.S. 478 (1985) 13

United States v. Crawley, 837 F.2d 291 (7th Cir. 1988) 11

Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co., Inc.), 834 F.2d 599 (6th Cir. 1987) 16

STATUTES

11 U.S.C. § 363 ..... *passim*

11 U.S.C. § 364 ..... *passim*

11 U.S.C. § 502 9

11 U.S.C. § 549 1

28 U.S.C. § 158 9

28 U.S.C. § 1334 8

OTHER AUTHORITIES

16 J. MOORE, *ET AL.*, MOORE'S FEDERAL PRACTICE § 108.70[1] (3d ed. 2004) 8

4A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1070 (3d ed. 2002) 8

TABLE OF AUTHORITIES – Continued

Page

RULES

Fed. R. Bankr. P. 8001 ..... 3, 8, 11, 13

Fed. R. Bankr. P. 9014 13

Sup. Ct. R. 10 2

BRIEF IN OPPOSITION

This is Capital's consolidated response in opposition to the petitions ("Petitions") of Knight-Ridder, Inc. ("Knight-Ridder"), Handleman Company ("Handleman"), and Irving Pulp & Paper, Limited ("Irving") for a writ of certiorari to review the decision ("Decision") of the U.S. Court of Appeals for the Seventh Circuit ("Seventh Circuit") in *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004). For the reasons set forth below, the Petitions should be denied.

INTRODUCTION

Through the Decision, the Seventh Circuit affirmed the reversal of a "critical-vendors" order in the chapter 11 bankruptcy case of Kmart Corporation ("Kmart"). The critical-vendors order gave Kmart open-ended authority, on the first day of its bankruptcy case, to pay the prepetition debts of certain suppliers it deemed "critical" in the exercise of its unilateral discretion. *Kmart,* 359 F.3d at 868-69. Kmart fully paid the prepetition debts of approximately 2330 suppliers. *Id.* In contrast to those suppliers, which collectively received about $300 million, Kmart's remaining unsecured creditors eventually received about 10¢ on the dollar on account of their claims, mostly in the form of reorganized Kmart stock. *Id.*

Under the authority of the critical-vendors order, Kmart paid in full the prepetition claims of Knight-Ridder, Handleman, and Irving (collectively, the "Petitioners"). However, the district court subsequently reversed the critical-vendors order. Facing potential liability for the recovery of those now-unauthorized payments from Kmart in pending adversary proceedings brought under § 549 of

the Bankruptcy Code,[1] the Petitioners seek this Court's review of the Seventh Circuit's Decision to affirm the reversal of the critical-vendors order.

The Petitions[2] articulate no compelling reason for granting certiorari in accordance with Sup. Ct. R. 10. As described below, they take liberties with the record, distort the Decision, and rely on inapposite authorities. The Petitions should be denied for the following reasons:

- Though Knight-Ridder takes issue with the Seventh Circuit's application of § 363(b) to the critical-vendors order, its Petition fails to demonstrate any inconsistency between the Seventh Circuit's analysis and those of other circuit courts that have applied § 363(b) in different contexts. Moreover, as the Seventh Circuit stated, "[w]e need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1)." *Kmart*, 359 F.3d at 872.

- Notwithstanding Handleman's contentions to the contrary, neither the critical-vendors order nor the district court's subsequent reversal of that order was an *in personam* judgment against Handleman. They were *in rem* orders. Handleman's Petition proceeds from a fundamental misunderstanding of the *in rem* nature of bankruptcy jurisdiction, and it ignores the Seventh Circuit's reliance

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[1] Unless otherwise indicated, all statutory references relate to the U.S. Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.* (2004).

[2] References to the Petitions of Knight-Ridder, Handleman and Irving are cited as "KP," "HP," and "IP," respectively.

on Fed. R. Bankr. P. 8001 for the rejection of Handleman's due process arguments. Handleman's quarrels with the Seventh Circuit's admonitions and dicta are no grounds for granting certiorari.

- Irving's Petition seeks an advisory opinion on a circuit split over the proper application of the mootness provisions of § 364(e). Regardless of whether the circuits are split, that issue is inapplicable to this case because the bankruptcy court did not authorize the critical-vendors order under § 364. Even if § 364(e) was applicable, no evidence was presented below to sustain a finding that Irving had acted as a "good faith" lender entitled to the protections of § 364(e).

REASONS FOR DENYING THE PETITIONS

I. Notwithstanding Knight-Ridder's Contention To The Contrary, The Seventh Circuit's Analysis Of § 363(b) Was Consistent With *Lionel* And Its Progeny.

Knight-Ridder contends that the Seventh Circuit's analysis of § 363(b) deviated from "the accepted judicial standard of section 363(b) approval." (KP at 2, 6-9.) In support of this contention, Knight-Ridder cites *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983) and its progeny. (KP at 6-8.)

Contrary to Knight-Ridder's contention, the Decision reflects a comparable analysis and rationale to that of *Lionel*. Like the Decision, *Lionel* instructs bankruptcy courts "to articulate sound business justifications for

[their] decisions," and "to further the diverse interests of the debtor, creditors and equity holders, alike," rather than "blindly follow[ing] the hue and cry of the most vocal special interest groups." *See Lionel*, 722 F.2d at 1066, 1071. Rather than demonstrating the Seventh Circuit's deviation from established standards for appellate review of § 363(b) orders, *Lionel* actually shows the Seventh Circuit's consistency.

In *Lionel*, the U.S. Court of Appeals for the Second Circuit ("Second Circuit") reviewed, and ultimately reversed, a bankruptcy court's order authorizing a chapter 11 debtor to sell its primary asset before a plan of reorganization could be considered. *Id.* at 1065. In confirming the sale, the bankruptcy court made no formal findings of fact; it "simply noted that cause to sell was sufficiently shown by the Creditors' Committee's insistence upon it." *Id.*

Concerned that an overbroad construction of § 363(b) "swallows up Chapter 11's safeguards" such as plan disclosure and voting requirements, the Second Circuit "reject[ed] the view that § 363(b) grants the bankruptcy judge *carte blanche*." *Id.* at 1069. Instead, the Second Circuit instructed bankruptcy judges determining § 363(b) requests to make express findings from the evidence presented before them that there is "some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b)." *Id.* at 1070-71. In fashioning its findings, a bankruptcy judge "should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike."

Id. at 1071. Mere creditor appeasement was "insufficient as a matter of fact because it is not a sound business reason and insufficient as a matter of law because it ignores the equity interests required to be weighed and considered under Chapter 11." *Id.*

As Knight-Ridder points out, other circuit courts have adopted the *Lionel* approach to § 363(b). *See, e.g.*, *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986); *Institutional Creditors of Cont'l Airlines, Inc. v. Cont'l Airlines, Inc. (In re Cont'l Airlines, Inc.)*, 780 F.2d 1223, 1226 (5th Cir. 1986). Though the Seventh Circuit ultimately determined that "[w]e need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because *this* order was unsound no matter how one reads § 363(b)(1)," its approach in the Decision was also similar to that of the Second Circuit in *Lionel*. *Kmart*, 359 F.3d at 872-74. The Seventh Circuit reviewed the "scant record" for evidence that could justify the purported reasons for the critical-vendors order, and, like the Second Circuit in *Lionel,* it did not consider the appeasement of a vocal special interest group to be an appropriate basis for approval under § 363(b). *Id.*

As the Seventh Circuit noted, "[t]he foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones." *Kmart*, 359 F.3d at 872. For that premise to hold true, a showing must be made that "supposedly critical vendors would have ceased deliveries if old debts were left unpaid." *Id.* at 873. However, the bankruptcy court "did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made." *Id.* at 874. In other words, neither the debtor nor the bankruptcy

court articulated a valid reason for the entry of the critical-vendors order.[3]

Moreover, the Seventh Circuit found that a critical-vendors order could not stand under § 363(b) unless it is supported by a showing that disfavored creditors are either likely to receive a benefit or will be no worse off from the requested payments. *Id.* at 873-74. The weighing and consideration of disparate interests in the context of a § 363(b) request is consistent with the approach taken in *Lionel*. *Lionel*, 722 F.2d at 1071 ("In fashioning its findings [on a § 363(b) application], a bankruptcy judge must . . . act to further the diverse interests of the debtor, creditors and equityholders, alike."). Since the record provided no such showing, the Seventh Circuit, like the Second Circuit in *Lionel,* could not allow the bankruptcy court's order to stand. *See Kmart*, 359 F.3d at 874.

As *Lionel* and the Decision both instruct, bankruptcy courts should not serve as a rubber stamp of the debtor's business judgment when they are presented with a § 363(b) request. They must insist on an articulation of that judgment and make express findings to that effect from the evidence presented before them. They must also ensure that vocal special interest groups are not unduly swaying the course of the bankruptcy case at the expense of other competing interests.

For the foregoing reasons, Knight-Ridder has failed to show that the Decision deviated from any established

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[3] As the bankruptcy court itself noted, "[m]otions to pay critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them." (KP at 66a.)

standard of appellate oversight on § 363(b) issues. Its Petition should be denied accordingly.[4]

II. Handleman Ignores The Seventh Circuit's Holding And Focuses Upon Its Dicta.

A. The Handleman Petition reflects a fundamental misunderstanding of the *in rem* nature of the critical-vendors order and the district court's reversal of that order.

The Handleman Petition rests on an erroneous premise – that the reversal of the critical-vendors order was an *in personam* judgment against Handleman. (HP at 12-14.) As the Seventh Circuit concluded, however, the critical-vendors order concerned Kmart and the use of its property, and it created no rights or interests in favor of anyone but Kmart. *See Kmart,* 359 F.3d at 870. Just as the critical-vendors order was not an *in personam* judgment for or against Handleman or any other creditor, neither was its reversal by the district court. Both were exercises of *in*

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[4] Knight-Ridder also contends that the Decision conflicted with this Court's decision in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 525 (1984). (KP at 8-10.) The *Bildisco* case dealt with the rejection of a collective bargaining agreement under § 365, an issue and a section of the Bankruptcy Code that are not applicable to this case. *See Bildisco*, 465 U.S. at 516. Nevertheless, Knight-Ridder contends that the Decision conflicts with this Court's endorsement of the "policies of flexibility and equity built into Chapter 11 of the Bankruptcy Code." *Id.* at 525. For the same reasons that the Decision is consistent with *Lionel,* as stated above, it is also consistent with this Court's reasoning in *Bildisco* and its corresponding concern that bankruptcy courts balance the "multiple, competing considerations underlying a Chapter 11 reorganization" through a "reasoned finding on the record" why chapter 11 policy will be served by the requested action. *See id.* at 526-27.

rem jurisdiction over Kmart and its property; personal jurisdiction over Handleman is irrelevant.

Bankruptcy courts have exclusive jurisdiction over a debtor's property, wherever located, and over the bankruptcy estate. *See* 28 U.S.C. § 1334(e). Because the exercise of that jurisdiction is premised on the debtor and its estate, and not on the creditors, bankruptcy courts are able to enter binding orders through their *in rem* jurisdiction without the necessity of acquiring *in personam* jurisdiction over any particular creditors. *Tenn. Student Assistance Corp. v. Hood*, 124 S. Ct. 1905, 1911, 1914 (2004) (citing 4A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1070 at 280-81 (3d ed. 2002) (noting jurisdiction over the person is irrelevant if the court has jurisdiction over the property)). Indeed, "[a] bankruptcy court's *in rem* jurisdiction permits it to 'determin[e] all claims that anyone, whether named in the action or not, has to the property or thing in question. The proceeding is "one against the world."'" *Id.* at 1911 (quoting 16 J. MOORE, *ET AL.*, MOORE'S FEDERAL PRACTICE § 108.70[1] at 108-106 (3d ed. 2004)); *see also Local Loan v. Hunt*, 292 U.S. 234, 241 (1934) ("generally, proceedings in bankruptcy are in the nature of proceedings *in rem*").

The critical-vendors order was an exercise of the bankruptcy court's *in rem* jurisdiction over Kmart and its property. As such, it was binding on all Kmart creditors, whether or not they received notice or participated in the bankruptcy court's hearing on the matter. Though the critical-vendors order mentioned Handleman, it gave no relief of any sort to Handleman or any other vendor. (*See* HP at 29a, ¶ 9.) Consequently, when Capital appealed from the critical-vendors order, it correctly named Kmart as the only other party to the order. *See* Fed. R. Bankr. P. 8001(a)

(notices of appeal in bankruptcy must name "all parties to the judgment, order, or decree appealed from").

Upon the filing of Capital's notice of appeal, the district court assumed jurisdiction over the critical-vendors order and its subject matter. *See* 28 U.S.C. § 158(a). *See also Griggs v. Provident Consumer Disc. Co.*, 459 U.S. 56, 58 (1982) (the filing of a notice of appeal confers jurisdiction on the appellate court and divests the lower court of its control over those aspects of the case involved in the appeal). Like the bankruptcy court, the district court did not require personal jurisdiction over Handleman because it did not determine any personal claim by or against Handleman. Rather, it reviewed the propriety of the critical-vendors order and its grant of authority to Kmart to use its property for the payment of certain prepetition claims prior to plan confirmation. Since the district court's jurisdiction, like the bankruptcy court's, was "premised on the res, not on the persona," its exercise was nonetheless binding on Handleman and all other Kmart creditors, "whether named in the action or not." *See Hood*, 124 S. Ct. at 1911.[5]

[5] In a separate adversary proceeding, reorganized Kmart has sought affirmative relief against Handleman to recover the payment that it received under the authority of the critical-vendors order. (*See* HP at 10.) Therefore, in contrast to the critical-vendors order and its subsequent reversal, any judgment in that proceeding *will* require the exercise of personal jurisdiction over Handleman because the judgment will be premised on the persona and not on the res. *Cf. Hood*, 124 S. Ct. at 1911. In the event that reorganized Kmart recovers any funds from Handleman on account of that judgment, Handleman will be entitled to a claim against the Kmart bankruptcy estate to be treated in accordance with Kmart's confirmed chapter 11 plan. *See* 11 U.S.C. § 502(h).

Handleman's primary citations for its jurisdictional argument are inapposite because they involve *in personam* judgments. *See, e.g., Richards v. Jefferson County*, 517 U.S. 793, 798 (1996); *Martin v. Wilks*, 490 U.S. 755, 761-62 (1989); *Helicopteros Nationales De Colombia, S.A. v. Hall*, 466 U.S. 408, 412 (1984). *Richards* and *Martin* certainly emphasize the "principle of general application in Anglo-American jurisprudence that one is not bound by a judgment *in personam* in a litigation in which he is not designated as a party." *Richards*, 517 U.S. at 798; *Martin*, 490 U.S. at 761. However, they also emphasize an exception to that general principle "where a special remedial scheme exists expressly foreclosing successive litigation by nonlitigants *as for example in bankruptcy. . . .* " *Richards*, 517 U.S. at 798-99 (emphasis added); *Martin*, 490 U.S. at 762 n.2 (emphasis added). *See also Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 846 (1999) (acknowledging the same exception). Handleman ignores the bankruptcy exception.

Consequently, Handleman's jurisdictional argument has no merit. No conflict exists between the Decision and this Court's decisions regarding *in personam* judgments because personal jurisdiction is irrelevant in this case. The district court's reversal of the critical-vendors order was an appropriate exercise of *in rem* jurisdiction that is binding on Handleman and all other entities. Handleman's request to be carved out from the binding effect of that reversal is inappropriate and must be denied accordingly.

B. The Seventh Circuit correctly short-circuited Handleman's due process argument because (i) the critical-vendors order granted no rights to Handleman, and (ii) Handleman had no consequent property interest at stake in the district court appeal.

The Handleman Petition misstates the Seventh Circuit's rationale for rejecting Handleman's due process argument. In rejecting Handleman's due process argument, the Seventh Circuit held that (1) Handleman was not a party to the critical-vendors order, (2) neither Handleman nor any other party acquired any rights under the order, and (3) Capital correctly followed Fed. R. Bankr. P. 8001 when it named only Kmart in its notice of appeal from the critical-vendors order. *See Kmart,* 359 F.3d at 870. Instead of addressing the Seventh Circuit's holding, Handleman's Petition focuses upon its dicta,[6] which present nothing for this Court to review. *See Stickel v. United States,* 76 S. Ct. 1067, 1068 (1956). *See also Black v. Cutter Labs.,* 351 U.S. 292, 297 (1956) ("This Court . . . reviews judgments, not statements in opinions.").

Contrary to Handleman's inaccurate contention that the Seventh Circuit "saw no problem with Handleman's Due Process Rights being skipped at the District Court

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[6] Specifically, Handleman complains about the Seventh Circuit's observations that (1) the precedential impact of its Decision has the same practical effect as its preclusive impact, and (2) it permitted Handleman to intervene in the appeal in any event. (HP at 18-22.) Handleman also complains about the Seventh Circuit's admonition that Handleman should have paid more attention to its $49 million stake in the case. (HP at 22-23.) Since these statements could have been deleted from the Decision without seriously impairing the analytical foundation of the Seventh Circuit's holding, they constitute dicta. *See United States v. Crawley,* 837 F.2d 291, 292 (7th Cir. 1988).

stage" (*see* HP at 18), the Seventh Circuit actually found that the critical-vendors order gave no rights to Handleman or any other creditor. *See Kmart,* 359 F.3d at 870. Consequently, Handleman had no due process interest at stake when the district court conducted its appellate review of the critical-vendors order.

The procedural requirements of due process, notice, and an opportunity to be heard apply only to the deprivation of constitutionally protected interests, liberty, and property. The "range of interests protected by procedural due process is not infinite." *Bd. of Regents v. Roth*, 408 U.S. 564, 569-70 (1972) (a college professor with a one-year contract had no constitutionally protected interest requiring due process, notice, and hearing before his contract was not renewed). Handleman acquired no interest from the critical-vendors order that was entitled to due process protection. (*See* HP at 29a, ¶ 9 ("nothing contained herein shall create, nor is it intended to create, any rights in favor of, or enhance the status of any claim held by, any person").[7] Consequently, Handleman's due process argument, like Professor Roth's, was appropriately rejected. *See Roth*, 408 U.S. at 569-70.

Moreover, as the Seventh Circuit noted, Handleman received better notice and a better opportunity to be heard with respect to Kmart's critical-vendors motion than Capital and most of Kmart's other creditors. *Kmart,* 359

[7] Handleman erroneously contends that both the critical-vendors order and Kmart's underlying motion identified Handleman "as having a 'particularized interest' in the matter." (*See* HP at 7.) Contrary to Handleman's contentions, neither the critical-vendors order nor the underlying motion contain any such language. (*See* HP at 24a-32a; IP at 45a-63a.)

F.3d at 870. *See also Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950) (The right to be heard has worth when "one is informed that the matter is pending and can choose for himself whether to appear or default, acquiesce or contest."). Handleman, however, chose neither to participate as a litigant in the bankruptcy court, file an appearance, intervene pursuant to Fed. R. Bankr. P. 2018, nor seek notice pursuant to the case management order entered in Kmart's bankruptcy case. Kmart, as the movant, and Capital, as the sole objector, were the only parties to the contested matter surrounding Kmart's critical-vendors motion. *See* Fed. R. Bankr. P. 9014. Consequently, Handleman did not become a party to the critical-vendors order, and it therefore was not entitled to notice of Captial's subsequent appeal. *See* Fed. R. Bankr. P. 8001.

The authority relied upon by Handleman to support its due process argument is easily distinguished from this case. Unlike the numerous cases cited by Handleman, the district court's order of reversal did not strip or bar any liens, claims, or other property interests Handleman may have had with respect to Kmart or its estate. *Cf., e.g., Tulsa Prof'l Collection Servs. v. Pope*, 485 U.S. 478, 488-89 (1985) (creditor's claim barred in probate case); *Mennonite Bd. of Missions v. Adams*, 462 U.S. 791, 792-95 (1983) (mortgagee's property interest foreclosed through tax sale); *Armstrong v. Manzo*, 380 U.S. 545, 550 (1965) (deprivation of parental rights); *Mullane*, 339 U.S. at 320 (two types of claims barred by trust accounting proceeding); *City of N.Y v. N.Y, N.H. & H.R. Co.*, 344 U.S. 293, 297 (1953) (involving the loss of a tax lien claim).[8]

[8] Handleman's reliance on *City of N.Y.* in support of its due process arguments is also misplaced because that case was decided on statutory rather than constitutional grounds. *See GAC Enters., Inc. v. Medaglia*

(Continued on following page)

Moreover, as stated above, the reversal of the critical-vendors order resolved no personal claim or affirmative relief by or against Handleman. *Cf., e.g., Nelson v. Adams USA, Inc.*, 529 U.S. 460, 463-64 (2000) (involving personal liability for costs and attorneys' fees); *Ortiz*, 527 U.S. at 821 (mandatory class action aggregating damages claims). By reversing the critical-vendors order, the district court merely clarified the bankruptcy court's lack of authority to allow Kmart to pay the prepetition claims of their trade creditors under the doctrine of necessity or § 105(a). (HP at 16a-19a.) It entered no *in personam* relief for or against Handleman or any other creditor. As a result, Handleman's due process argument has no merit, and the Seventh Circuit appropriately rejected the argument.

III. Irving's Petition Seeks An Advisory Opinion On The Scope Of § 364(e).

Irving's Petition proceeds from the mistaken premise that § 364 of the Bankruptcy Code formed a basis for the bankruptcy court's critical-vendors order. Notwithstanding Irving's constant assertions to that effect, however, § 364 formed absolutely no basis for the entry of the order. (*See* IP at 29a-35a.) The plain meaning of the order and the absence of any reference to § 364 in the record refute Irving's assertions. Regardless of whether a circuit split exists on the scope of § 364(e), as Irving asserts in its Petition, the resolution of that split is irrelevant to this case.

(In re Medaglia), 52 F.3d 451, 455-57 (2d Cir. 1995); *Grossie v. Sam (In re Sam)*, 894 F.2d 778, 781 (5th Cir. 1990).

The express purpose of the critical-vendors order was the payment of prepetition trade claims, not the incurrence of postpetition trade credit. Entitled "Order Under 11 U.S.C. § 105(a) Authorizing The Payment Of Prepetition Claims Of Certain Critical Trade Vendors," the critical-vendors order stated that the "Debtors are authorized, but not directed, in the reasonable exercise of their business judgment, to pay all, a portion or none of the prepetition claims" of so-called critical vendors. (IP at 29a-30a.) Though the order instructed Kmart to pursue "customary trade terms" in exchange for critical-vendor payments, its authorized discretion to make those payments was not conditioned upon the receipt of postpetition trade credit. (IP at 31a-33a.)

The sole statutory basis expressed for the critical-vendors order was § 105. (IP at 29a.) The order did not mention § 364. (*Id.*) Moreover, the record shows that (1) Kmart's critical-vendors motion neither raised nor mentioned § 364 (IP at 47a ("[t]he statutory predicates for the relief sought herein are section 105(a) of the Bankruptcy Code")), and (2) neither Kmart nor any other party presented testimony or other evidence at the bankruptcy court's hearing on the critical-vendors motion to establish grounds for relief under § 364.[9] (KP at 44a-75a.) Capital, therefore, had no reason or opportunity to cross-examine witnesses, rebut testimony, or contest any fact or argument

[9] After presenting its critical-vendors motion to the bankruptcy court at the "first-day" hearing of its bankruptcy case, Kmart presented its motion ("DIP Financing Motion") for authority to obtain $2 billion in postpetition financing pursuant to §§ 105, 361, 362, 364(c)(2), and 364(c)(3). Kmart presented evidence and testimony to establish the grounds for relief under § 364 *specific* to the DIP Financing Motion but only *after* the bankruptcy court had entered the critical-vendors order.

relating to § 364 with respect to the critical-vendors motion. As a result, neither the bankruptcy court nor the district court were given any opportunity to rule on any issue under § 364 in connection with the critical-vendors order.

Irving's Petition is based upon a circuit split over the proper application of § 364(e) to bankruptcy financing orders that permit "cross-collateralization." Except for the Decision, however, the decisions that Irving cites in support of its contention involve bankruptcy financing orders that were entered under the auspices of § 364. (*See* IP at 9-12 (comparing (i) *In re Adams Apple, Inc.*, 829 F.2d 1484, 1488 (9th Cir. 1987) and *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanaba (In re Ellingsen MacLean Oil Co., Inc.)*, 834 F.2d 599, 604 (6th Cir. 1987); (ii) *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1493 (11th Cir. 1992); and (iii) *Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)*, 16 F.3d 552, 562 (3d Cir. 1994)).)

None of the decisions that Irving cites involved the extension of § 364(e) to an order entered under a provision of the Bankruptcy Code other than § 364. *Id.* In fact, the U.S. Court of Appeals for the Ninth Circuit ("Ninth Circuit") later clarified and distinguished its earlier decision in *Adams Apple* by holding that financing orders entered under a section of the Bankruptcy Code other than § 364 are not shielded from appeal by virtue of § 364(e). *See Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.)*, 945 F.2d 1089, 1095 (9th Cir. 1991) (finding *Adams Apple* to be inapplicable because the underlying bankruptcy court order was entered under § 365, not § 364).

Like the Ninth Circuit in *Sun Runner*, the Seventh Circuit correctly concluded that the mootness provisions of § 364(e) did not apply to the critical-vendors order. *See Kmart*, 359 F.3d at 869. Contrary to Irving's contention that the Seventh Circuit "concluded that the protections of section 364(e) do not apply because the bankruptcy court's approval of the [critical-vendors order] was erroneous" (IP at 21), the Seventh Circuit actually and correctly determined that § 364(e) is irrelevant because the critical-vendors order was not a § 364 financing order. *See Kmart*, 359 F.3d at 869. The Seventh Circuit refused to "invent missing language" in the Bankruptcy Code to shelter the critical-vendors order from appeal. *Id.*

Section 364(e) is inapplicable to the critical-vendors order for at least two reasons.[10] First, the plain language of § 364(e) only shelters bankruptcy court authorizations "*under this section* to obtain credit or incur debt, or of a grant under this section of a priority or a lien . . . [or] the validity of any debt so incurred, or any priority or lien so granted. . . . " 11 U.S.C. § 364(e) (emphasis added); *Saybrook*,

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[10] The reasoning of the Seventh Circuit's decision in *In re EDC Holding Co.*, 676 F.2d 945, 948 (7th Cir. 1982) provides an additional reason for the inapplicability of § 364(e) to the critical-vendors order. In *EDC Holding*, the Seventh Circuit held that § 364(e) would not moot an appeal where the underlying credit transaction evidently effected an improper purpose under the Bankruptcy Code. *EDC Holding*, 676 F.2d at 948. The use of § 364 to pay prepetition unsecured claims is improper because such payments (i) are not authorized under the plain terms of § 364, and (ii) are contrary to the fundamental priority scheme of the Code. *See Saybrook*, 963 F.2d at 1494-95. *See also Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990) (Section 364 orders "do not allow a creditor to boost the priority of existing loans."). Consequently, § 364(e) does not shield such payments from subsequent appeals. *See Saybrook*, 963 F.2d at 1494-95; *EDC Holding*, 676 F.2d at 948.

963 F.2d at 1493; *Sun Runner*, 945 F.2d at 1095. As explained above, Kmart's critical-vendors motion sought no authority either to incur debt or grant a priority or a lien under § 364; it only sought leave to *pay* prepetition debts under § 105(a). (*See* IP at 45a-46a.) Furthermore, Capital's subsequent appeal did not affect the "validity of any debt" or "any priority . . . granted . . . " to Irving as a result of Kmart's critical-vendors motion because, as the Seventh Circuit noted in its Decision, (1) "*no* creditor acquired rights" in the critical-vendors order (IP at 35a, ¶ 9 ("nothing herein shall create . . . any rights in favor of, or enhance the status of any claim held by, any person")), and (2) critical vendors such as Irving "have been paid in full for post-petition goods and services." *Kmart*, 359 F.3d at 870. Consequently, on its face, § 364(e) cannot apply to the critical-vendors order. *See Saybrook*, 963 F.2d at 1493; *Sun Runner*, 945 F.2d 1095.

Second, § 364(e) only protects the validity of any debt or the priority of any lien granted under § 364 to an "entity that extended such credit in *good faith*. . . . " 11 U.S.C. § 364(e) (emphasis added). Because Kmart's critical-vendors motion was not brought under § 364, however, the critical-vendors order lacked the support of any findings that Kmart, Irving, or any of the other vendors were acting in good faith as § 364(e) requires. *See N.Y. Life Ins. v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 901 F.2d 1359, 1367 (6th Cir. 1990) (holding that "an implicit finding of 'good faith' in a § 364(e) context is insufficient and that 'good faith' under that section should not be presumed"); *see also In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143,

148-49 (3d Cir. 1986) (to the same effect in a case under § 363(m)). Irving's good faith cannot be presumed.[11]

Moreover, Irving's good faith is belied to the extent that its insistence on the payment of its prepetition claims violated the automatic stay. *See* 11 U.S.C. § 362. *See also EDC Holding*, 676 F.2d at 948 (a creditor fails to act in good faith if it acts for an improper purpose). If, as Kmart alleged in support of its critical-vendors motion (IP at 57a, ¶ 27) and as Irving appears to confirm in its Petition,[12] the critical vendors were leveraging their refusal to deal with Kmart on a postpetition basis in order to collect their prepetition debts, then those creditors were violating the automatic stay arising from Kmart's bankruptcy filing by virtue of § 362(a). *Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (In re Sportfame of Ohio, Inc.)*, 40 B.R. 47, 50 (Bankr. N.D. Ohio 1984) (refusal to ship goods to coerce payment of prepetition debt violates § 362(a)(6)). *Accord Lansdale Family Rests., Inc. v. Weis Food Serv. (In re Lansdale Family Rests., Inc.)*, 977 F.2d 826, 829 (3d Cir. 1992) (application of postpetition payment to prepetition debt violates § 362(a)(3)); *Andrews Univ. v. Merchant (In re Merchant)*, 958 F.2d 738, 741-42 (6th Cir. 1992) (the refusal to issue a transcript until a debtor pays a prepetition debt

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[11] Irving contends that its good faith is not an issue because the record below shows "no indication that Irving extended credit in bad faith." (IP at 22.) However, that contention ignores the fact that the record below contained no findings of good faith because Kmart did not seek the entry of the critical-vendors order pursuant to § 364. Moreover, Irving erroneously implies that it is entitled to a presumption of good faith that must be rebutted by evidence of bad faith.

[12] Irving readily admits that "unpaid vendors often raise their prices on post-petition shipments to recoup pre-petition losses from bankrupt debtors if they have the leverage to do so, and sophisticated debtors, such as Kmart, are aware of this." (IP at 27.)

violates § 362(a)(6)). Thus, either Irving and the other critical vendors were violating the automatic stay and acting in bad faith in leveraging the payment of prepetition debts through the critical-vendors order, or the alleged factual predicate of Kmart's critical-vendors motion was a fabrication. Either way, Irving is not entitled to the protections of § 364(e).

The Irving Petition, at its essence, constitutes a request for an advisory opinion from this Court on the split that exists between the circuits over the application of § 364(e) to bankruptcy financing orders that allow the cross-collateralization of a creditor's prepetition debt. That circuit split is a purely academic question in the context of this case because the critical-vendors order was not entered or authorized under § 364, which means that § 364(e) is inapplicable on its face. Therefore, even if Irving was successful in convincing this Court to resolve the circuit split, the subsequent resolution would not solve Irving's problem. The shelter of § 364(e) would not extend to the § 105 critical-vendors order in any event. *See Sun Runner*, 945 F.2d at 1095.

This Court does not render advisory opinions; it only resolves concrete controversies. *See, e.g., Diamond v. Charles*, 476 U.S. 54, 61-62 (1986); *Ashcroft v. Mattis*, 431 U.S. 171, 172-73 (1977); *Ruth v. Delano,* 338 U.S. 226, 231 (1949). Irving's Petition should be denied accordingly.

CONCLUSION

For the foregoing reasons, the Petitions for a writ of certiorari from this Court to the Seventh Circuit should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

IRVING PULP & PAPER, LIMITED d/b/a IRVING PAPER,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF

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RULE 29.6 STATEMENT

Petitioner's Corporate Disclosure Statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that Statement.

TABLE OF CONTENTS

Page

Rule 29.6 Statement i

Table of Contents ii

Table of Cited Authorities iii

I. The Decision of the Court Below Squarely Conflicts with the Decisions of Other Courts of Appeals. 2

II. The Proper Construction of Section 364(e) Is Unquestionably of Sufficient Importance to Warrant Review in this Court 7

III. Certiorari Is Also Warranted Because the Decision Below Is Wrong on the Merits ... 9

Conclusion 10

TABLE OF CITED AUTHORITIES

Page

Federal Statutes:

11 U.S.C. § 362(b) 5

11 U.S.C. § 362(c) 5

11 U.S.C. § 362(d) 5

11 U.S.C. § 363(m) 3

11 U.S.C. § 364 5

11 U.S.C. § 364(a) 5

11 U.S.C. § 364(e) ..... *passim*

REPLY BRIEF FOR PETITIONER

There is no real dispute that this case squarely presents a three-way circuit conflict over whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification. Attempting to sidestep the issue, Capital argues that review is not warranted because the bankruptcy court did not properly enter the Vendor Order under section 364 of the Bankruptcy Code. (Cert. Op. at 14-18). But that is both untrue and beside the point. Regardless of whether the bankruptcy court properly entered its order, the question presented — and the issue over which the courts of appeals are divided — is whether an appellate court has the authority to overturn such an order under section 364(e) absent a stay pending appeal or the creditor's bad faith.

As demonstrated in Irving's petition, other courts of appeals have concluded that, under section 364(e), an appellate court may not overturn an order of the bankruptcy court authorizing the priority payment of a creditor's pre-petition claim in exchange for the creditor's post-petition extension of credit unless the prerequisites of section 364(e) are satisfied. (Pet. at 12-17). In contrast, the court below concluded that section 364(e) does not impose these limitations on appellate review of the same kind of order. Specifically, the Seventh Circuit concluded that it could exercise plenary review over the Vendor Order and overturn its priority payment authorization even though Irving had already extended credit. (Pet. App. 4a, 9a). The Seventh Circuit's resolution of the question presented thus falls squarely within the conflict among the courts of appeals over the proper application of section 364(e).

Ultimately, Capital does not deny that Irving extended post-petition credit to Kmart in exchange for Kmart's priority treatment of Irving's pre-petition invoice in accordance with

the express terms of the Vendor Order. Nor does Capital dispute that the court below actually decided the question presented or the existence of a three-way circuit conflict on this question. Likewise Capital has no response to Irving's showing that the issue is important, that this Court's resolution of the question presented is outcome-determinative, or that the court below was wrong on the merits. Similarly, Capital does not dispute the enormous cost and inequity involved in the current prosecution of thousands of lawsuits against Irving and other trade vendors arising from the decision of the court below seeking the return of approximately $300 million in payments that Kmart made under the Vendor Order. Because the question presented is vitally important and recurring, and is one over which the courts of appeals are intractably divided, certiorari should be granted.

I. The Decision of the Court Below Squarely Conflicts with the Decisions of Other Courts of Appeals.

Section 364(e) is directed exclusively to the authority of an appellate court to review the decision of a bankruptcy court approving the terms of a financing transaction. In this case, the court of appeals expressly acknowledged that section 364(e) does "forbid revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court separated Kmart's ability to obtain post-petition trade credit from *the terms* of the credit transaction as a whole — specifically Kmart's elevation of the vendors' pre-petition claims to post-petition priority status in exchange for their agreement to extend credit. The court concluded that section 364 "authorizes the debtor to obtain credit (as Kmart did), but has nothing to say about . . . priorities among creditors." (Pet. App. 9a). Accordingly, the court exercised plenary review over the treatment of the vendors' pre-petition claims under the Vendor Order

irrespective of any question of good faith or Capital's failure to obtain a stay, holding that "the critical-vendors order cannot stand." (Pet. App. 14a).

On this vital question, the decision of the court below falls squarely within the circuit split identified in Irving's petition. As noted, the Ninth and Sixth Circuits have ruled that, absent bad faith or a stay pending appeal, section 364(e) shields from appellate review the terms of a credit transaction that includes the priority treatment of the creditor's pre-petition claim regardless of whether the transaction was wrongfully approved. (Pet. at 9-11). In contrast, the Eleventh Circuit, together with the court below, have ruled that section 364(e) provides no such protection. (Pet. at 14-17).

As further noted in the Petition, the decision of the court below likewise conflicts with the decisions of the Third and Tenth Circuits under section 364(e). (Pet. at 15-17). Moreover, the divergent approaches taken by the courts of appeals under section 364(e) mirrors a larger split of authority under section 363(m) — a companion provision of the Bankruptcy Code that is virtually identical to section 364(e). (Pet. 17-20). Within this larger group of cases, the decision of the court below conflicts with the decisions of *ten* other courts of appeals applying the nearly identical standards of sections 364(e) and 363(m). Because the Seventh Circuit's decision in this case falls squarely within the scope of an existing and intractable circuit conflict, the petition should be granted.

Rather than address either the merits of the decision of the court below under section 364(e), the question presented, the split of authority among the circuits, the importance of the question, or any other relevant consideration, Capital fixates on what it contends are flaws in the Vendor Order itself. But the merits of the Vendor Order are beside the point.

Even assuming that a bankruptcy court's financing order arguably lacks merit, the question presented centers on an *appellate* court's authority to review the merits of the order absent a stay or the creditor's lack of good faith.

Critically, Capital does not (and cannot) deny that the Seventh Circuit actually decided the question presented in conflict with the decisions of other courts of appeals. Instead, Capital argues that the Seventh Circuit essentially decided a moot point because Capital believes that the case could be disposed of on the ground that the bankruptcy court did not properly enter or label the Vendor Order as a "financing order." (Cert. Op. at 15). This argument, however, is meritless and provides no basis for denying the petition.

Critically, Capital nowhere denies that the Vendor Order is, in fact, a financing order. Indeed, the order itself lays this issue to rest. By its terms, the Vendor Order expressly authorized Kmart to pay Irving's pre-petition claim in exchange for Irving's agreement to extend post-petition trade credit. (Pet. App. 30a-33a).

Moreover, Capital does not (and cannot) deny that, acting in accordance with the provisions of the order, Irving actually extended post-petition trade credit to Kmart in exchange for Kmart's payment of Irving's pre-petition invoice. As Irving accurately summarized in its petition:

> After the bankruptcy court entered the Vendor Order, Irving agreed to the provisions of the Order and commenced shipping tens of millions of dollars worth of goods to Kmart on favorable credit terms. In turn, Kmart paid Irving's pre-petition invoice in the amount of approximately $3.5 million as an expense of administration and thereafter Kmart paid Irving for its post-petition

> shipments. In addition, Irving relinquished any lien or reclamation rights that it had with regard to the goods that it had shipped.

(Pet. at 5). Thus, regardless of whether the parties might have consummated a different transaction with different pricing and payment terms, Irving in fact complied with the terms of the order and extended post-petition credit to Kmart in exchange for the priority payment of its pre-petition claim.

Section 364(e) plainly applies to the transaction that the bankruptcy court approved between Irving and Kmart in this case. Under section 364, a debtor may be authorized to incur post-petition debt, or obtain post-petition credit, in one of two basic ways. First, the debtor may obtain credit in the ordinary course of its business without a court order. *See* 11 U.S.C. § 364(a); (Pet. 2-3). Second, the debtor may obtain credit other than in the ordinary course of its business pursuant to a court order. *See* 11 U.S.C. §§ 362(b), (c) & (d); (Pet. 3-4). Section 364(e) shields both situations from appellate intervention, expressly providing that

> [t]he reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended credit in good faith . . . unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

11 U.S.C. § 364(e). Significantly, section 364(e) applies not only to the approved financing itself, but also, without limitation, to any priority or lien granted as part of the financing transaction.

Whether or not the bankruptcy court's authorization of the transaction in this case was necessary or proper is simply irrelevant if section 364(e) applies to shield review of the merits of the Vendor Order in the absence of a stay or the creditor's bad faith. Critically, that is not only the question decided below, it is also one on which the courts of appeals are divided and is likewise the question presented in Irving's petition.

Capital suggests that the Vendor Order was not a true financing order because the standard credit provisions of the order *could* have been altered through negotiation. (Opposition at 15). Capital asserts that, under the order, Kmart might have agreed to pay the pre-petition invoice of a particular creditor without obtaining the creditor's agreement to extend post-petition credit on terms favorable to Kmart if necessary to prevent irreparable harm to Kmart's estate. (*See* Pet. App. at 33a). This argument, however, is also meritless and supplies no ground for denying the petition. As noted, Irving and Kmart in fact complied with the standard financing provisions set forth in the Order, and not the alternative, hypothetical transaction that Capital identifies.

Further, Capital does not contend that any other trade vendor actually had its pre-petition invoice paid without agreeing to extend credit post-petition to Kmart as contemplated by the standard provisions of the order. Moreover, Capital does not deny that resolution of the question presented is outcome-determinative. In this case, if Irving prevails, it may keep the approximately $3.5 million that it received. On the other hand, if Irving loses in this Court, then it faces having to return the payment (as do thousands of other trade creditors who are similarly situated). Irving obviously does not seek an advisory opinion. Instead, Irving seeks the resolution of a live controversy over which the courts of appeals are intractably divided.

Capital argues further that review is not warranted on the theory that it is possible that Irving may not have extended its post-petition trade credit in "good faith." (Cert. Op. at 18-20). This argument, however, actually illustrates why certiorari should be granted. The concept of good faith is relevant only if the appellate court first recognizes the statutory restrictions that section 364(e) imposes because it is section 364(e) that imposes the good faith requirement in the first place as a prerequisite to appellate review. In this case, the Seventh Circuit did not address the question of good faith because the court applied a plenary standard of review in conflict with the decisions of other courts of appeals.

In addition, Capital's argument is immaterial because Capital never challenged Irving's good faith in any proceeding below and has no grounds for asserting that Irving acted in bad faith because none exist. The best that Capital can offer is its speculation that, "to the extent" Irving may have taken certain actions, then perhaps Irving's good faith might be challenged. (Cert. Op. at 19). But Capital cannot say that Irving actually did anything wrong (because Irving did not) and Capital's claim is thus purely imaginary. Moreover, to the extent that any question of good faith remains, it is separable and may be addressed on remand if necessary.

II. The Proper Construction of Section 364(e) Is Unquestionably of Sufficient Importance to Warrant Review in this Court.

Capital has no answer to Irving's demonstration that the question presented is of vital importance to the administration of business reorganization cases. Every day, creditors extend millions of dollars worth of essential credit to chapter 11 debtors in reliance on the protections of section 364(e). Unlike credit transactions between lenders and financially

healthy obligors outside the bankruptcy setting, credit transactions in chapter 11 cases involve insolvent debtors and are subject to any creditor's objection in the bankruptcy court. Lenders understand this, and thus appreciate that, without the protections of section 364(e), their credit transactions would be subject to the uncertainty of unbridled appellate scrutiny. In enacting the Bankruptcy Code, Congress concluded that this uncertainty would chill the provision of necessary credit in bankruptcy, and crafted section 364(e) accordingly.

The clear and obvious effect of the decision below is to undo the protections that Congress has prescribed. Creditors faced with the prospect of having their transactions undone on appeal after they have extended credit will be far less likely to lend to chapter 11 debtors. Worse, creditors who are sued for the recovery of the payments that they received following an appellate court's reversal of a transaction on which they relied will have even less incentive to return to the bankruptcy credit market.

Likewise, Capital has no response to Irving's showing regarding the enormous cost and inequity arising from the thousands of lawsuits that have been brought against the numerous trade vendors such as Irving who extended credit and received payment of their pre-petition invoices on the strength of the Vendor Order. By disregarding the protections of section 364(e), the court below has unleashed a flood of litigation that is only likely to be repeated in future chapter 11 proceedings. Moreover, for a significant number of the trade vendors in this case, being forced to return the payments that they have received may well precipitate their own bankruptcy filings. This is precisely an inequity that section 364(e) was designed to avoid and review in this Court is necessary to address this serious problem.

III. Certiorari Is Also Warranted Because the Decision Below Is Wrong on the Merits.

Capital also has no answer to Irving's demonstration that the decision of the court below is wrong on the merits. The Seventh Circuit's ruling in this case effectively leaves nothing of substance to section 364(e) because, under the court's standard, as long as the court disagrees with the payment terms in a financing order, it may reverse the order even though the lender acted in good faith and the appellant failed to obtain a stay pending appeal. In contrast, most other courts that have addressed the issue under section 364(e), and *every* other circuit to have addressed the same issue under section 363(m), have concluded that an appellate court's authority is circumscribed by the statutory restrictions.

Not surprisingly, the payment terms of a financing transaction are the ones most likely to engender controversy in a disputed transaction, rather than the bare fact that the debtor has obtained credit. Likewise, for the creditor, the payment terms are most likely to be the most important aspect of the transaction. The Bankruptcy Code provides no warrant for a court of appeals to second-guess the price of credit in bankruptcy absent the lender's bad faith or the issuance of a stay pending appeal before the transaction is consummated. The Seventh Circuit's decision to the contrary is not only unwarranted under the Code, it defies Congress' assigned roles regarding the supervision of credit transactions in bankruptcy settings.

CONCLUSION

This case presents a frequently recurring question that is essential to the orderly operation of the bankruptcy laws. This case likewise presents a question of law over which the courts of appeals are staunchly divided. For the foregoing reasons, as well as those set forth in the petition, Irving respectfully requests that the Court issue a writ of certiorari to review the decision of the Seventh Circuit.

Respectfully submitted,

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IN THE

Supreme Court of the United States

IRVING PULP & PAPER, LIMITED d/b/a IRVING PAPER,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION OF TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA, THE EVERETT HERALD, THE REGISTER GUARD, THE SEATTLE TIMES CO., THE WALLA WALLA UNION BULLETIN, AND THE YAKIMA HERALD REPUBLIC FOR LEAVE TO FILE BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION AND BRIEF *AMICI CURIAE*

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MOTION FOR LEAVE TO FILE BRIEF

Pursuant to Rule 37.2 of the rules of this Court, *Amici Curiae* Travelers and Surety Company of America ("*Travelers*"), the Everett Herald, the Register Guard, The Seattle Times Co., the Walla Walla Union Bulletin, and the Yakima Herald-Republic (together, "*Newspapers*" and with Travelers, "*amici*") hereby move for leave to file a brief *amicus curiae* in support of the petition for a writ of *certiorari* filed by Irving Pulp Paper, Limited d/b/a Irving Paper ("*Irving Paper*").*

As more fully explained in the accompanying brief, each of the *amici* had commercial relationships with Kmart Corporation ("*Kmart*") prior to the commencement of its chapter 11 bankruptcy. After filing for bankruptcy protection, Kmart was in immediate need of trade credit and surety bond capacity.

The *amici* agreed to continue their relationships with Kmart through credit transactions by which the Newspapers rendered advertising and distribution services on favorable terms and Travelers and other sureties provided financial accommodations to Kmart in the form of surety bonds. In consideration for the trade credit and financial accommodations, Kmart provided for priority treatment and payment of certain prepetition claims and, for the sureties, provision of collateral.

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* Petitioner Irving Paper consented to the submission of the accompanying brief. Capital Factors, Inc. declined to extend its unconditional consent to the filing of the accompanying brief.

After notice and a hearing, these credit transactions were approved by orders of the bankruptcy court that were not subject to any stay. The orders were fully implemented and the credit transactions consummated. In the end, thousands of creditors, including *amici*, extended billions of dollars of postpetition trade credit and financial accommodations to Kmart in reliance on the approval orders.

Pursuant to section 364(e) of the Bankruptcy Code, *amici* and other creditors were entitled to rely on the effectiveness and protections of those approval orders, free from the uncertainty of appellate review. 11 U.S.C. § 364(e). As a result of the decision below, creditors were deprived of the benefit of their bargains and the protections Congress afforded to encourage them to provide credit to debtors. The appeals of the approval orders should have been dismissed. Instead, the court of Appeals for the Seventh Circuit has deepened the conflict among the circuit courts and burdened the administration of the bankruptcy laws with inequity and uncertainty. Review of the lower court decision is warranted.

The petition filed by Irving Paper provides a compelling basis for granting a writ of *certiorari*. The accompanying brief will assist the Court in determining whether to grant *certiorari* because: (1) *amici* can more broadly inform this Court of the enormous inequity, uncertainty, and burdens engendered by the lower court's decision; (2) the accompanying brief addresses additional points to provide substantial support for Irving Paper's petition; and (3) *amici* speak to the inequitable and onerous adverse consequences of the lower court's decision on future chapter 11 cases.

Accordingly, *amici* respectfully request that the Court grant leave to file the accompanying brief *amicus curiae*.

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TABLE OF CONTENTS

	Page
Table of Cited Authorities	ii
Statement	1
Prepetition Relationships	1
Credit Transactions	2
Appeal	4
Reasons for Granting the Petition	8
I. The Decision Of The Court Of Appeals For The Seventh Circuit Deepens A Mature And Irreconcilable Conflict Among The Courts Of Appeals On The Issue Of Whether And To What Extent Bankruptcy Code Section 364(e) Protects An Order Approving A Credit Transaction From Subsequent Appellate Modification	8
II. Certiorari Is Further Warranted Because Resolution Of The Conflict In The Lower Courts Over The Question Presented Is Vital To The Orderly Administration Of The Bankruptcy Laws	10
Conclusion	11

TABLE OF CITED AUTHORITIES

CASES *Page*

Boullioun Aircraft Holding Co., Inc. v. Smith Mgmt. (In re Western Pacific Airlines, Inc.), 181 F.3d 1191 (10th Cir. 1999) 8

Burchinal v. Central Washington Bank (In re Adams Apple, Inc.) 829 F.2d 1484 (9th Cir. 1987) 8, 9

Capital Factors, Inc. v. Kmart Corporation, 291 B.R. 818 (N.D. Ill. 2003) 1, 4, 5

In re Forty-Eight Insulations, Inc., 115 F.3d 1294 (7th Cir. 1997) 5

Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A, 530 U.S. 1 (2000) 3

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) 6

In re Kmart Corp., 359 F.3d at 866 (7th Cir.) 5, 6

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1983) .. 11

Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992) 9

In re Statmore, 177 B.R. 312 (Bankr. D. Neb. 1995) 3

Cited Authorities

Page

The Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.), 16 F.3d 552 (3d Dir. 1994) 10

In re UNR Industries, Inc., 20 F.3d 766 (7th Cir. 1994) 7

Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. (In re Ellingsen MacLean Oil Co.), 834 F.2d 599 (6th Cir. 1987) 8, 9

STATUTES

11 U.S.C. § 363(m) 6, 7

11 U.S.C. § 364(e) ..... *passim*

RULE

Fed. R. Bankr. P. 8005 5

BRIEF OF THE *AMICI CURIAE*

Amici Curiae Travelers Casualty and Surety Company of America ("*Travelers*"), the Everett Herald, the Register Guard, The Seattle Times Co., the Walla Walla Union Bulletin, and the Yakima Herald Republic (together "*Newspapers*") submit this brief in support of the petition filed by Irving Pulp & Paper, Limited d/b/a Irving Paper ("*Irving Paper*") for a writ of *certiorari* to the United States Court of Appeals for the Seventh Circuit.[1]

STATEMENT

This matter arises out of the chapter 11 reorganization of Kmart Corporation and certain of its affiliates and subsidiaries ("*Kmart*").

Prepetition Relationships

Prior to Kmart's filing for bankruptcy, the Newspapers were critical vendors who rendered advertising and distribution services as part of Kmart's extensive advertising and weekly circular distribution program which generated $11 billion of Kmart's annual sales.

Prior to Kmart's filing for bankruptcy, Travelers and other sureties issued surety bonds to secure the financial requirements of Kmart and without which Kmart could not lawfully engage in certain businesses or obtain essential services in numerous states.

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1. This brief has been authored in its entirety by undersigned counsel for the *amici curiae*. No person or entity, other than the named *amici* and their counsel, made any monetary contribution to the preparation and submission of this brief.

Credit Transactions

Upon the commencement of its chapter 11 bankruptcy cases, Kmart required immediate access to credit and continuation of its surety bond programs in order to continue its operations.

After the bankruptcy filing, the Newspapers agreed to continue to render their vital services to Kmart on the same trade (credit) terms as Kmart enjoyed prior to its bankruptcy for a period of at least two years and to waive liens and limit reclamation claims, if any.

For their part, Travelers and other sureties agreed to rescind prepetition cancellation notices on certain bonds, reinstate and renew certain bonds, and issue new bonds, all in accordance with their applicable surety bond programs.

In consideration for these benefits Kmart agreed to provide the following: (a) for the Newspapers, Kmart agreed to treat the prepetition claims as administrative expenses and pay them; and (b) for Travelers and the other sureties, Kmart agreed to pay prepetition obligations backed by surety bonds, acknowledge certain priority treatment for the claims of sureties, and provide collateral to secure Kmart's obligations under the surety bonds and related indemnity agreements.

The Bankruptcy Code broadly authorizes debtors to obtain credit or incur debt. 11 U.S.C. § 364. The statute does not prescribe or limit the terms of the credit transactions but does requires in almost all instances (other than transactions in the ordinary course of business) bankruptcy court approved after notice and hearing. Transactions for the provision of trade credit between Kmart and the Newspapers is certainly

within the ambit of section 364. *See Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A*, 530 U.S. 1, 12 (2000); *In re Statmore*, 177 B.R. 312, 313-14 (Bankr. D. Neb. 1995) (advertising and telephone services).

On January 25, 2002, after notice and a hearing, the bankruptcy court approved Kmart's proposed form of credit transaction and entered its corresponding order ("*Vendor Order*"). Likewise, by order entered on March 22, 2002 ("*Surety Order*"), the bankruptcy court approved the continuation of the surety bond programs. It cannot be gainsaid that the transactions approved by the Vendor Order and the Surety Order—the extension of trade credit and the provision of financial accommodations—fit firmly within the ranks of section 364 transactions; accordingly, the parties to those transactions are entitled to the protections of section 364(e).

The Vendor Order and Surety Order were implemented and the credit transactions authorized by them were consummated. Pursuant to the Vendor Order, the Newspapers rendered vital advertising and distribution services on credit terms to Kmart and afforded Kmart the certainty that its extensive advertising program, critical to the ongoing health of its business, would continue on favorable credit terms. In consideration for the extension of postpetition credit, the Newspapers were paid, as administrative expenses, the amount of their prepetition claims.

Pursuant to the Surety Order, Travelers and other sureties reinstated and renewed prepetition bonds and continued their surety bond programs without which Kmart could not do business or obtain services or lawfully operate in numerous states. In consideration for such financial accommodations,

Kmart paid surety-backed obligations, accorded certain surety claims priority treatment, and secured certain surety-related obligations with collateral.

To enhance a debtor's ability to promptly obtain necessary credit and thus facilitate its policies of successful rehabilitation and preservation of going concerns, Congress provided comprehensive protection to creditors who extend credit in good faith by insulating their approved credit transactions from reversal or modification on appeal unless a stay of the order approving the credit transaction is imposed:

> [T]he reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, of a grant under this section of a priority or lien, does not affect the validity of any debt so incurred, or any priority or lien so granted . . . unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

11 U.S.C. § 364(e).

Appeal

Meantime, on February 1, 2002, without seeking or obtaining a stay, Capital Factors, Inc. ("*Capital*") took an appeal from the Vendor Order. An appeal (again without stay) was taken from the Surety Order but was later resolved without appellate review. Over fourteen months later, on April 8, 2003, the district court reversed the Vendor Order and overturned the credit transactions approved by that order. *Capital Factors, Inc. v. Kmart Corporation*, 291 B.R. 818 (N.D. Ill.).

The district court determined that approval of the component of the credit transaction providing for the payment of critical suppliers' prepetition claim amounts in exchange for postpetition credit was erroneous. Regarding the mootness of the appeal due to substantial consummation of the credit transactions and payment of vendors' claims, the district court stated that Capital was not required to obtain a stay to preserve its appellate rights. 291 B.R. at 823. Further, the district court excused Capital's failure to obtain a stay, speculating that a motion to stay would not likely have been granted by the bankruptcy court. However, the district court ignored Capital's unexercised ability to bring a stay motion in the district court. *See In re Forty-Eight Insulations, Inc.*, 115 F.3d 1294, 1298 n.3 (7th Cir. 1997); Fed. R. Bankr. P. 8005 (motion for stay pending appeal "must ordinarily be presented to the bankruptcy judge in the first instance").

By its decision dated February 24, 2004 ("*Kmart Decision*"), the Seventh Circuit affirmed the district court's order reversing the Vendor Order. The circuit court unbundled the credit transaction, determining that section 364(b) authorized Kmart to obtain unsecured postpetition credit or to incur unsecured debt, but that the price for such credit in the form of administrative expense priority for prepetition claim was impermissible. *In re Kmart Corp.*, 359 F.3d 866, 872 (7th Cir.).

The circuit court acknowledged that section 364(e) prohibited "revision of transactions completed under judicial auspices" and cited DIP financing orders as entitled to such protection. *Id.* at 869. In this, the Seventh Circuit Court reiterated its prior observation that under section 364(e) "a lender that extends credit in reliance on a financing order is entitled to the benefit of that order, even if it turns out to

be legally or factually erroneous." *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1355 (7th Cir. 1990). Nonetheless, having unbundled the Vendor Order credit transaction, the circuit court held that section 364 and its protections do not apply where a creditor's grant of postpetition credit is provided in consideration for the priority treatment of certain prepetition claims and the payment of those claims as administrative expenses. 359 F.3d at 872.

The circuit court also acknowledged that reversing the Vendor Order would result in actions by Kmart to recover the payments made to critical vendors, oblivious to its earlier observation in *Kham & Nates* that depriving lenders of the certainty of their transactions will deter lending to debtors:

> [B]ankruptcy judges may make *lending* commitments to give priority to new credit. If creditors fear that the rug will be pulled out from under them, they will hesitate to lend. So § 364(e) . . . disable[s] courts from backtracking on promises in the absence of bad faith, which is a very narrow exception.

908 F.2d at 1355 (emphasis in original, citations omitted).

Rejecting section 364 as a source of authorization to the portion of the credit transaction providing for administrative expense status and payment, the circuit court then examined whether the payment was authorized under section 363(b)(1) under which a debtor "may use, sell, or lease, other than in the ordinary course of business, property of the estate." The Court concluded that the Vendor Order was "unsound" under section 363(b)(1), but having introduced the alternative

section 363 analysis, the Court failed to consider whether section 363(m), a companion provision to section 364(e), might appropriately prohibit appellate courts from depriving creditors of protections previously approved by a prior court order.

> Several provisions of the Bankruptcy Code of 1978 provide that courts should keep their hands off consummated transactions. For example, 11 U.S.C. § 363(m) says that reversal of an order authorizing the sale or lease of property of the estate "does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith. . . . " Unless the sale is stayed pending appeal, the transaction survives even if it should not have been authorized in the first place.

In re UNR Industries, Inc., 20 F.3d 766, 769 (7th Cir. 1994).

As the Seventh Circuit forecast, Kmart has commenced thousands of lawsuits to recover hundreds of millions of dollars paid to vendors in exchange for their agreement to provide critically important goods and services on favorable credit terms. As a result, vendors who provided credit in reliance upon the Vendor Order are now being deprived of the protections afforded by section 364(e) and are being stripped of their benefits.

REASONS FOR GRANTING THE PETITION

I.

The Decision Of The Court Of Appeals For The Seventh Circuit Deepens A Mature And Irreconcilable Conflict Among The Courts Of Appeals On The Issue Of Whether And To What Extent Bankruptcy Code Section 364(e) Protects An Order Approving A Credit Transaction From Subsequent Appellate Modification

By the Kmart Decision, the Seventh Circuit deprives creditors of the benefit of their postpetition credit transactions and the protection of section 364(e) which would otherwise insulate such court-approved transactions from appellate reversal. It deepens a mature and irreconcilable conflict among the Courts of Appeals.

The Sixth and Ninth Circuits have concluded that section 364(e) protects from appellate reversal or modification a credit transaction approved by the bankruptcy court and for which no stay has been obtained. *See Burchinal v. Central Washington Bank* (*In re Adams Apple, Inc.*) 829 F.2d 1484 (9th Cir. 1987); *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co.* (*In re Ellingsen MacLean Oil Co.*), 834 F.2d 599 (6th Cir. 1987); *see also Boullioun Aircraft Holding Co., Inc. v. Smith Mgmt.* (*In re Western Pacific Airlines, Inc.*), 181 F.3d 1191 (10th Cir. 1999) (following *Adams Apple*).

Both circuits view section 364 as a broad mandate to induce postpetition extensions of credit to the bankruptcy estate while neither prescribing nor proscribing permissible terms of the credit transaction.

Thus in the Ninth Circuit's view, section 365 authorizes bankruptcy courts to permit the use of a variety of financial devices, including priority treatment of a creditor's prepetition claim. *In re Adams Apple*, 829 F.2d at 1488.

Likewise, in *Ellingsen*, the Sixth Circuit evaluated a credit transaction as a whole package, including an agreement to forego a challenge to prepetition liens, and determined that the credit transaction was authorized under section 364. *In re Ellingsen*, 834 F.2d at 602.

Cognizant of the congressional intent to promote investment in businesses in bankruptcy, both circuits view their appellate role in narrow terms.

In the absence of a stay pending appeal, the appellate court will uphold a credit transaction between a debtor and a good faith creditor that falls within the broad intent of section 364, even if bankruptcy court approval was erroneous.

In sharp contrast, the Eleventh Circuit has construed the protections of section 364(e) more narrowly and rejected the reasoning of the circuit courts in *Adams Apple* and *Ellingsen*. *Shapiro v. Saybrook Mfg. Co.* (*In re Saybrook Mfg. Co.*), 963 F.2d 1490, 1493 (11th Cir. 1992). In *Saybrook*, the circuit court held that section 364(e) does not protect a credit transaction in which a lender's prepetition claim is accorded priority treatment in exchange for a postpetition extension of credit. *Id.* In its Kmart Decision, the Seventh Circuit has joined the Eleventh Circuit, depriving creditors of the benefit of their credit transactions with debtors after determining that a component of the transaction is not permitted under section 364.

The Third Circuit compounds this conflict among the circuit courts by espousing yet another view of the protections of section 364(e). Notwithstanding a creditor's good faith and the absence of a stay pending appeal, the Third Circuit holds that a bankruptcy order approving a section 364 credit transaction may be modified so long as the credit transaction has not been fully consummated. *The Resolution Trust Corp. v. Swedeland Dev. Group, Inc.* (*In re Swedeland Dev. Group, Inc.*), 16 F.3d 552 (3d Cir. 1994). The Third Circuit acknowledges its disagreement with the Ninth and Sixth Circuits. *Id.* at 562.

These divisions among the circuit courts are of long-standing and acknowledged by the courts themselves. The conflicting circuit courts' views concerning whether and to what extent section 364(e) protections are available warrant review by this Court to resolve the conflict.

II.

Certiorari Is Further Warranted Because Resolution Of The Conflict In The Lower Courts Over The Question Presented Is Vital To The Orderly Administration Of The Bankruptcy Laws

Credit transactions are approved in virtually every chapter 11 case. Orders concerning critical vendors are now a mainstay in nearly every major chapter 11 reorganization.

In the Kmart case alone, thousands of creditors extended billions of dollars of credit pursuant to credit transactions that were approved by the bankruptcy court.

The Vendor Order approving the credit transactions was not stayed and was fully implemented. The credit transactions were consummated by creditors acting in good faith and in

reliance on the comprehensive protection afforded by the plain language of section 364(e).

The Kmart Decision deprives these creditors of the protections upon which they relied and subjects them to lawsuits and the disgorgement of hundreds of millions of dollars years after they had fully performed their part of the bargain and extended credit to a newly-filed chapter 11 debtor in need of credit to operate and to promote a successful reorganization.

The inequity to these creditors in the Kmart case is manifest. The detrimental impact on future bankruptcy cases is predictable. If this Court does not review and reverse the Kmart Decision, creditors will be far less likely to do business with debtors, an outcome decidedly at odds with the goal of chapter 11 to promote reorganization. *See NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1983).

CONCLUSION

For the foregoing reasons, the writ of certiorari should be granted.

Respectfully submitted,

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